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Articles

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The Great Depression of 1946

Richard K. Vedder and Lowell Gallaway*

It seems inevitable that some Ph.D. student in economics some time soon will pick up a recent copy of the *Economic Report of the President* looking for a dissertation topic and learn that there was a Great Depression in 1946, a topic which he or she will then analyze using all the tools of modern economic analysis. The student will read that real gross national product in 1946 fell 19 percent, the largest single decrease in annual output in the century of recorded annual GNP data.[1] He or she will also learn quickly that from 1944 to 1947, real output fell by 22.7 percent. Looking up population figures, the student will observe that per capita output actually declined by more than one-fourth in real terms over the three years of conversion from war to peace, and did not regain the pre-depression (1944) level until 1964.[2]

From all of this the student will no doubt conclude that the heretofore neglected Great Depression of 1946 was the worst cyclical downturn in modern American economic history, and that by some measures it had a greater disruptive impact on the American economy than the earlier, more celebrated Great Depression of 1929–41. For example, in the earlier downturn, real per capita GNP surpassed the 1929 peak levels within 12 years, compared with 20 years it took to surpass the 1944 peak after the 1946 depression. Moreover, while the 1929–33 downturn was quantitatively a bit larger (30 percent vs. 23 percent), no single year exhibited a decline of the magnitude of that witnessed in 1946.

If the student is typical of most economics students today, he or

*Richard K. Vedder and Lowell Gallaway are distinguished professors of economics and faculty associates of the Contemporary History Institute at Ohio University. Some material is adapted with permission from the forthcoming book *Unemployment and the State* by Lowell Gallaway and Richard Vedder to be published by the Independent Institute, Oakland, California.

[1]See, for example, the 1990 *Economic Report of the President* (Washington, D.C.: Government Printing Office, 1990), pp. 296, 301.

[2]In 1982 dollars, the decline is from $9,976 in 1944 to $7,401 in 1947. Population data used in this calculation are from U. S. Bureau of the Census, *Historical Statistics of the United States, Colonial Times to 1970* (Washington, D.C.: Government Printing Office, 1975).

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she will lack a historical perspective. Therefore, that individual no doubt will fail to observe that the Great Depression of 1946 has been worsening every decade. In 1960, when *Historical Statistics of the United States, Colonial Times to 1957* was published, the reported decline in real GNP in 1946 was but 7.8 percent, and for the three years 1944–47 just 9.8 percent, hardly a great depression.[3] When the next edition of *Historical Statistics* was published in 1975, however, the 1946 decline was a more robust 12 percent, and the total business cycle downturn (1944–47) saw a drop in real output of 14.2 percent.[4]

By 1981, when the Department of Commerce reported revised national income data, the 1946 drop had reached a truly "depressing" 14.7 percent, with the episodic decline reaching 17.4 percent.[5] Five years later, in 1986, the 1946 depression truly earned the label of "great" when the latest revisions in statistics revealed the 19 percent drop discussed above. *The Great Depression of 1946 seems to be getting constantly worse, and if current trends continue should soon pass the 1929 depression in magnitude by any criteria.*

If our mythical student looks further in the *Economic Report of the President*, he or she will get even more puzzled and, perhaps, excited. The student will learn that the sharp decline in GNP occurred with unemployment rates below four percent, far below the normal peacetime rate in the twentieth century, either before or after the 1946 "depression."

He or she will also learn that this relatively full employment was achieved despite an extraordinarily contractionary fiscal policy. The federal budget deficit on a national income accounts basis in 1944 was some $54.5 billion, equal to 25.8 percent of GNP. That would be the equivalent in 1990 (in relation to GNP) of a deficit of about $1,400 billion. By 1947, the federal budget was in *surplus* by $13.4 billion, or 5.7 percent of GNP. The equivalent today (in relation to GNP) would be well over a $300 billion surplus. Among other things, the government in pursuing this extraordinarily contractionary fiscal policy fired (or "released from employment") roughly 20 percent of the total labor force. All of this had little impact on unemployment.

We know of no episode in American economic history that more

[3]See *Historical Statistics of the United States, Colonial Times to 1957* (Washington, D.C.: Government Printing Office, 1960), p. 139.

[4]Ibid., p. 224.

[5]U.S. Department of Commerce, Bureau of Economic Analysis, *The National Income and Product Accounts of the United States, 1929–1976: Statistical Tables* (Washington, D.C.: Government Printing Office, 1981), p. 6.

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keenly illustrates several insights from Austrian economics than the 1944–47 business-cycle experience. The ultimate irony is that the modern historical interpretation of that era suggests that it was a period that demonstrated the superiority of Keynesian economic doctrines. It was in this period that the death knell came to residual sentiments among the American economics profession that market coordination is the most appropriate and efficient means to assure reasonably "full" employment of productive resources. Politically, it was during this period that the federal government institutionalized Keynesian-style macroeconomic intervention with the Employment Act of 1946.

Despite the statistics cited above, conventional modern wisdom is that the transition from war to peace proceeded without a major downturn after World War II, and certainly there was no "depression."[6] Our subsequent discussion will show that interpretation is essentially correct. However, it is generally accepted that the smooth economic conversion resulted from "pent up" demand for consumer goods offsetting the reduction in defense spending. In other words, the Keynesian prescription that "demand creates its own supply" worked after World War II.

After studying this historical episode, we conclude the following:

(1) Conventional wisdom is correct on one thing: there was no depression in 1946, or anything resembling one.

(2) Accordingly, aggregate economic statistics need to be viewed with a skeptical eye, particularly in periods such as this where there are pronounced governmental interventions in markets.

(3) The failure of the nation to enter a depression after 1944, however, reflected not pent-up consumer demand so much as the dramatically ameliorative effects of changing relative prices on the macroeconomy.

(4) The smooth transition to peace was accomplished despite the existence of a fiscal policy that was the very antithesis of Keynesian economic prescriptions to deal with falling aggregate demand. The most dramatically contractionary fiscal policy in modern American history failed to materially alter the pace of economic activity.

(5) Keynesian economics triumphed in politics and among academic economists at the very time that empirical evidence was clearly exposing its explanatory weaknesses. The very empiricist-

[6]This is not to deny, however, that there was a fair amount of economic discontent in the period. Because of continuing price controls into 1946, there were shortages of many consumer goods; labor strife ran high, with days missed because of work stoppages reaching a new peak.

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quantitative economists who rhetorically were selling the new economics of Keynes on the grounds that the evidence of the 1929–41 downturn showed the empirical bankruptcy of market-oriented economic doctrines were ignoring, perhaps deliberately, the 1944–47 empirical evidence that was devastating to the Keynesian paradigm.

(6) A market-Austrian intrepretation of this historical episode is very much more in keeping with the evidence.

Statistics *Do* Lie

Some official Department of Commerce statistics on this historical episode as they were published in 1960, and as they were published in 1990, are included in table 1. Note that every single series has somewhat different numbers in 1990 than in 1960. Changes are comparatively minor for money GNP, the civilian unemployment rate, and civilian unemployment, but they are substantial for price changes as measured by the GNP price deflator and, as a consequence, for real GNP. Table 2 summarizes the percent change in the five statistics over the 1944–47 period.

Between 1960 and 1990, government economists approximately doubled their estimate of the inflation occuring from 1944 to 1947, thereby causing the estimated real GNP decline to more than double.

Table 1
Some Key Economic Indicators
as Reported in 1960 and in 1990

Indicator	*Data Reported in 1960*		*Data Reported in 1990*	
	1944	*1947*	*1944*	*1947*
Civilian Unemployment Rate	1.2%	3.6%	1.2%	3.9%
Civilian Unemployment	670[a]	2,142[a]	670[a]	2,311[a]
GNP Price Deflator	115[b]	141[b]	15.3[c]	22.1[c]
Money GNP	$211.4[d]	$234.9[d]	$211.4[d]	$235.3[d]
Real GNP	$183.6[b,d]	$165.6[b,d]	$1,380.6[c,d]	$1,066.7[c,d]

[a]In thousands
[b]1929 dollars
[c]1982 dollars
[d]In billions

Sources: 1960 Data: *Historical Statistics of the United States, Colonial Times to 1957*; 1990 Data: *Economic Report of the President, 1990*.

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Table 2
Percent Changes in Key U. S. Economic Indicators, 1944–1947

Indicator	*1960 Data*	*1990 Data*
Civilian Unemployment Rate	+200.0%	+225.0%
Civilian Unemployment (No.)	+219.7%	+244.9%
GNP Price Deflator	22.6%	44.4%
Money GNP	11.1%	11.3%
Real GNP	–9.0%	–22.7%

Source: Calculated from data found in table 1 above.

Substantial price controls were in effect in 1944, but were essentially abandoned by 1947. Thus official statistics based on controlled prices should tend to understate true equilibrium prices in 1944, and overstate the true inflation at market-clearing prices observed between 1944 and 1947. Yet the statistical revisions have tended to *increase* the reported inflation from 1944 to 1947, not decrease it. Following from that, the revisions in statistics over time have reduced the reported inflation during World World II. For example, reading the 1990 *Economic Report of the President*, one learns that the GNP price deflator rose a modest 13.8 percent in the four years 1941 to 1945, a lower annual rate of inflation than prevalent in the past two decades.[7] Yet if one looks at, say, the 1978 *Economic Report*, the reported 1941–45 inflation is 20.3 percent.[8] A few years earlier, in the 1975 edition of *Historical Statistics*, the wartime inflation was 26.5 percent.[9] Picking up the 1960 version of *Historical Statistics*, however, the increase in prices was reported to be 29.7 percent.[10] As time passes, it looks like the government was increasingly successful in curtailing inflation in World War II, and increasingly unsuccessful in containing it in the postwar era.

To this point, the various data revisions certainly seem to give justification to a common Austrian suspicion of over-reliance on aggregate economic statistics, particularly price indices, in evaluating

[7]1990 *Economic Report to the President*, p. 298.
[8]1978 *Economic Report*, p. 260.
[9]*Historical Statistics*, p. 224.
[10]*Historical Statistics*, p. 139.

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the economy. Beyond that, the revisions serve to increase reported economic growth during the command economy era of World War II, and reduce it during the era in which there was a return to increased reliance on market forces in resource allocation, a conclusion that Austrians find hard to accept with equanimity.

Despite our suspicions to the contrary, we must concede, however, that it is possible that the earlier statistics were flawed, and that the revisions have served to paint a more accurate portrayal of the economic history of the period. Perhaps even there really was a major depression in 1946 that no one was perceptive enough to recognize at the time.

One way to evaluate that possibility is to try to ascertain what prices would have been in the 1942–48 period if various historical relationships observed earlier held. Using those forecasted or predicted prices, we can then estimate trends in real GNP using the money GNP statistics on which there has been virtually no data revision and little dispute (see, however, below).

We developed a model to predict the GNP price deflator for the period 1916 to 1941, the era immediately before the World War II experience where price controls were imposed. The years chosen were dictated largely by data considerations. Four independent variables were chosen, two financial in nature and two proxying for real output. The financial variables were *M2* and the interest rate on four- to six-month commercial paper; the "real variables" were ton-miles of class A railroad volume and the total number of employed workers.[11]

Ordinary least squares regression procedures were used to estimate the GNP price deflator during the 1916–41 period. Actual values for the four independent variables were used with the estimated regression coefficients and constant term to calculate a forecasted value of the GNP price deflator for 1942 to 1948. The forecasting was aided by the fact that the estimated regression had a relatively good statistical fit (R^2 = .822), with actual and estimated values being rather close for the years immediately preceeding the war. (See the appendix for more details.)

Taking the estimated GNP price deflator numbers for 1942–48, along with the accepted money GNP numbers, we calculated real GNP by year. In table 3, we present our estimates, along with the official estimates as they were reported in 1960 and 1990. Turning first to prices, we estimated that true equilibrium prices rose far more during World War II than any of the official estimates. Our estimate

[11]All statistics were gathered from the 1975 version of *Historical Statistics of the United States, Colonial Times to 1957*.

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Table 3
U.S. Price and Real Output Trends, 1941–48: Three Interpretations

	*Real GNP**			*GNP Price Deflator*		
Year	*1960 Data*	*1990 Data*	*Authors' Estimates*	*1960 Data*	*1990 Data*	*Authors' Estimates*
1941	100.0	100.0	100.0	100.0	100.0	100.0
1942	111.5	118.8	117.1	113.2	106.5	108.0
1943	122.7	140.3	128.0	124.2	109.4	119.7
1944	132.4	151.8	127.6	126.4	110.9	131.7
1945	130.4	149.0	116.1	129.7	113.8	146.1
1946	120.3	120.6	108.5	141.8	140.6	155.6
1947	119.4	117.3	115.7	154.9	160.1	161.6
1948	125.7	121.9	125.6	163.7	171.0	165.6

* Numbers are indexed, with 1941 = 100.
Source: see text.

is that prices rose 46 percent from 1941 to 1945, compared with official estimates varying, over time, between 24 and 30 percent. The historical experience from which our calculations were extrapolated was an era largely (although not completely) free of price controls. Our estimated price index thus incorporates the disguised inflation hidden by the existence of controls that was manifested in shortages, black markets, shoddy quality of goods or services, etc.[12]

By contrast, we estimate that while inflation continued after the war (imprudently, we might editorially add), in a meaningful sense it was far less than what has been reported, since repressed, disguised inflation came out in the open. We estimate prices rose about 13 percent from 1945 to 1948, a rather substantial inflation rate, but far less than observed during the war or reported by governmental officials (26 to 50 percent, depending on the date of the statistics).

Our estimates of price trends are very similar to estimates for the net national product price deflator derived by Milton Friedman and

[12]For a discussion of the history of the World War II controls, plus some of the difficulties that controls brought about, see U. S. Department of Labor, *The General Maximum Price Regulation*, Bulletin No. 879 (Washington, D.C.: Government Printing Office, 1946).

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Anna Schwartz.[13] They estimate price increases of nearly 44 percent for 1941–45, much closer to our 46 percent estimate than to the official estimates of 24–30 percent. Similarly, they obtain a 16 percent increase for the 1945–48 period, only moderately larger than our 13 percent figure. By contrast, our estimated wartime inflation is considerably higher than that estimated by Mills and Rockoff, which we believe is implausibly low.[14]

Dividing money GNP by the estimated deflator to get estimated real GNP, we get a rather different historical interpretation than what the government statistics, particularly the recent ones, suggest. Our scenario suggests output grew substantially during World War II, but far less than the recent government revisions would suggest (and moderately less than the earlier governmental data suggested). Moreover, our results suggest output peaked in 1943, then held steady in 1944. The official versions have output rising noticeably in 1944.

Our estimates suggest a peak-to-trough decline in real output of slightly over 15 percent, compared with nearly 23 percent with the current official government numbers. Not only is our estimate of the decline about one-third smaller than what the current numbers suggest, but it also suggests that much of the decline occurred in the latter part of the war itself. The estimated 1946 output drop was only 6.5 percent, less than that for 1945. Moreover, we estimate output rose in 1947, rather than fell. Since we calculated that the 1947 output increase almost offset the 1946 decline, we suggest there was virtually no decline in output from 1945 to 1947, compared with the current statistical data's suggestion of a decline of 21 percent (the 1960 data revealed a fall in output of slightly over eight percent).

Certainly our estimates are more consistent with the written commentary of the period, which emphasized the comparative smoothness of the transition from war to peace. They also are about what one would expect if one accepts the premise that wartime inflation was understated because of price controls, and consequently postwar inflation, while real, was overstated. Our estimates would seem consistent with the 1960 Department of Commerce data modified to take account of price interventions by the federal government.

[13]Milton Friedman and Anna J. Schwartz, *Monetary Trends in the United States and the United Kingdom* (Chicago: University of Chicago Press for the National Bureau of Economic Research, 1982).

[14]Geofrey Mills and Hugh Rockoff, "Compliance with Price Controls in the United States and the United Kingdom during World War II," *Journal of Economic History* 47 (March 1987).

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Whether our estimates are correct or not, it is clear that the aggregate government statistics on output, prices, etc., must be used with extreme caution, and that data "revisions" do not always bring about improved insight into historical phenomena.

Why the Error in the Government's Revised Statistics?

Why is it that the official GNP statistics for the reconversion period become continually worse over time? Examination of the calculation procedures used reveals that the recent estimates are a complete statistical artifact.

The aggregate GNP price deflator is the weighted sum of several component price indices, such as the personal consumption expenditures index (which, in turn, has several components), the index for exports, imports, government purchases of goods and services, and private investment. Numbers are indexed around a base year, currently 1982. Over time, the price index for the government purchases of goods and services has risen significantly more than for other components. For example, in 1982 it is estimated that the aggregate price of government goods and services averaged 8.13 times the 1946 level, compared with "only" a 4.55-fold increase in the price of consumer goods. Since 1982 is set equal to 100, that means the 1946 index number for the government goods and services price deflator is 12.3 (100 divided by 8.13); the figure for the personal consumption expenditure deflator is 22.0.

As reconversion proceeded, the weights used to measure consumption's contribution to the aggregate price index dramatically increased, while the weights used to measure government purchases contribution dramatically decreased.[15] Since the consumption index had

[15]A numerical example, suggested by an anonymous referee, might help the reader see the point.

	1946 as base year		*1949 as base year*	
Year	*Consumption Deflator*	*Government Deflator*	*Consumption Deflator*	*Government Deflator*
1946	100	100	40	25
1947	105	200	60	50
1948	200	300	80	75
1949	250	400	100	100

If the weights of the consumption and the government expenditures components of the GNP deflator in this hypothetical example were 60% and 40%, respectively, in 1947,

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a bigger number (22 in 1946) than the government purchases index (only 12.3), the calculated aggregate GNP deflator rose in part merely from the shift from government spending to consumer spending.

The 1990 data show the total GNP price deflator rose from 15.7 to 19.4 from 1945 to 1946, an increase of 23.6 percent. Yet the subcomponents of the index are all reported to have increased less—consumption by less than nine percent, investment by about 15 percent, government purchases by four percent, etc. Only by changing the weights and by arbitrarily giving higher numbers to the non-government purchases component of the index do you get this type of result, which is then used with nominal GNP data in calculating equally artificial real GNP. Had prices of governmental purchases risen exactly the same as other components in the index over time, the distortion would not have been observed. In earlier years, the distortion was smaller because the disparity between the government purchases price index and the other index components was much smaller than observed now (since the series have diverged more over time because of consistently faster rising prices of governmental goods and services).

Reevaluating Governmental Expenditures

It can be argued that even our estimates above *understate* the robustness of the postwar economy, and overstate wartime growth, because of a second flaw in the data. While transactions in the private market economy are appropriately valued for GNP calculations by using equilibrium prices, governmental purchases of goods and services may be overvalued, since they are not generally sold in a truly competitive market environment.[16]

Looking at it from the demand side, many consumers of governmental services are forced to "purchase" those services at a cost (reflected in taxes, inflation, or higher interest rates) above what the consumer would be willing to pay if permitted to buy the services on a non-coercive basis. Typically there is a "deadweight loss" as opposed to the consumer surplus typical in non-coercive market transactions. From the supply perspective, monopolistic governmental bureaucrats lack the incentive to minimize resource use, and thus services

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and 80% and 20% in 1948, then the deflator would have risen by 29.4 percent (from 170 to 220) between 1947 and 1948 using 1946 as the base year. If one uses 1949 as the base year, however, we would have calculated an increase of 41.1 percent (from 56 to 79) for the same period.

[16]For a study that carries the argument here much further than we have chosen to take it, see Robert Batemarco, "GNP, PPR, and the Standard of Living," *Review of Austrian Economics* 1 (1987): 181–86. See also Murray Rothbard, *America's Great Depression* (Kansas City: Sheed and Ward, 1963).

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are provided less efficiently than if sold competitively in the private market economy. This is probably why, for example, governmental purchase prices have risen more than private sector prices over time.

Suppose that during the 1941–48 period, governmental purchases of goods and services had a true value equal to 75 percent of the stated value used in calculating GNP. Suppose also the true GNP price deflator is as we have estimated it in table 3. Under these assumptions, real output rises but 18.8 percent from 1941 to 1943, falls very slightly in 1944 and by a bit over seven percent in 1945. The 1946 decline in real GNP is a paltry 1.1 percent. Output by 1947 is less than two percent below 1944 levels, and by 1948 output exceeded the wartime peak by about six percent (compared to a 19 percent decline using data in the 1990 *Economic Report of the President*).

We calculated the numbers in the previous paragraph to illustrate the importance of the assumption that government purchases of goods and services are valued at the amount of government expenditures. The 75 percent valuation chosen was arbitrary. For example, had 50 percent been used, there would have been a calculated *growth* in real GNP in 1946, and a noticeable decline in output in the late war years. What the true figure should be is debatable. Nonetheless, it seems highly likely to us that the true GNP growth during World War II tends to be seriously overstated because of the increasing relative importance of governmental expenditures, and tends to be understated in the postwar years because of the reverse phenomenon.

Simultaneous with our work, Robert Higgs has examined the real output question for the 1940s.[17] His conclusions are similar to ours; indeed Higgs goes further. Carefully examining the pioneering work of Simon Kuznets, the contributions of William Nordhaus and James Tobin, as well as others, Higgs believes World War II was not a period of prosperous growth that is typically depicted, and, more relevant to this paper, that there was prosperity and no downturn in the postwar reconversion period.[18] He believes, correctly in our judgment, that the military command economy of the war tended to lead to exessive output valuations that have led to fundamentally flawed national income statistics.

[17]Robert Higgs, "Wartime Prosperity? A Reassessment of the U. S. Economy in the 1940s," paper presented to the Cliometric Society meetings, Washington, D.C., December 1990.

[18]See, for example, Simon Kuznets, *National Product in Wartime* (New York: National Bureau of Economic Research, 1945); see also William Nordhaus and James Tobin, "Is Growth Obsolete?" in *Economic Growth*, NBER General Series 96 (New York: National Bureau of Economic Research, 1972).

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Economic Interpretations of the Postwar Reconversion

It was widely believed during the latter part of World War II that substantial unemployment would develop after the war. A review of forecasts by Michael Sapir confirms the fact that many economists believed a severe recession or depression was coming.[19] That view was held by most federal officials as well; as one well-known writer on the subject put it, "In the summer of 1945 the belief was fairly widely held in Washington that unemployment would be a serious problem during the winter of 1945–46 and a strong deflationary tendency was predicted."[20]

In part, the prediction of depression reflected the influence of the secular stagnationists, led by leading Keynesian disciple Alvin Hansen, who argued that the investment boom that had stimulated American economic growth had stalled after the closing of the frontier and the slowdown in population growth.[21] In part, it reflected a more short-term Keynesian concern with falling aggregate demand in the face of decreased government expenditures. The thought of a rapid reduction in government military spending provided nightmares to some Keynesians. Hansen, writing in 1943, said: "When the war is over, the government cannot just disband the Army, close down munitions factories, stop building ships, and remove all economic controls."[22] Yet that is precisely what the government did (although it took a year to remove most controls).

Politicians took the dire predictions of economists seriously. Speaking to the Congress a few days after the Japanese surrender, President Truman said of reconversion, "Obviously during the process there will be a great deal of inevitable unemployment."[23] Truman was concerned that a fall in purchasing power would retard recovery. In calling for an increase in the minimum wage and extended

[19]Michael Sapir, "Review of Economic Forecasts for the Transition Period," National Bureau of Economic Research, *Studies in Income and Wealth* 9 (March 1949): 275–351. One forecaster who correctly foresaw the low postwar unemployment was W. S. Woytinsky. See his "What Was Wrong in Forecasts of Postwar Depression?" *Journal of Political Economy* 55 (April 1947): 142–51. See especially his comment on page 143; see also Lawrence Klein's comment in Sapir, op. cit., pp. 352–57.

[20]Robert A. Gordon, *Business Fluctuations*, 2nd ed. (New York: Harper and Row, 1961), p. 464. Everett Hagen's forecast, for example, predicted an unemployment rate of 14.8 percent for the first quarter of 1946. See Sapir, op. cit., p. 332.

[21]Alvin Hansen, "Economic Progress and Declining Population Growth," *American Economic Review* 29 (March 1939): 1–15.

[22]In a publication for the National Resources Planning Board, *After the War, Full Employment*, quoted in Hugh S. Norton, *The Employment Act and the Council of Economic Advisers, 1946–1976* (Columbia, S.C.: University of South Carolina Press, 1977).

[23]*New York Times*, September 7, 1945, p. 16, col. 3.

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coverage, Truman said "the existence of substandard wage levels sharply curtails the national purchasing power and narrows the markets for the products of our firms and factories."[24]

A few days earlier, the prestigious Committee for Economic Development, representing 2,900 businessmen and headed by prominent industrialist Paul G. Hoffman (Chairman of the Studebaker Corporation) called for federal aid to assist the newly created jobless to move to areas where jobs were created.[25]

At the same time, however, the use of two conventional Keynesian unemployment remedies, tax cuts and public works projects, was largely rejected. Truman did call for the passage of a Full Employment Act, but proposed little in the way of new public works spending or tax relief to stimulate aggregate demand.[26] Indeed, prominent Republicans were more vehement in calling for income tax cuts than the Democrats, with the ranking Republican member of the House Ways and Means Committee calling for a 20 percent income tax cut.[27] The *New York Times*, summarizing Congressional feelings on public works spending, concluded:[28]

> Only a short time ago, the tendency at the nation's capital was to think in terms of public works as a major factor. It now seems to be agreed that they should be regarded only as a part of a broad program, or as a last resort in an emergency, and that private enterprise must be relied upon to provide the large-scale employment necessary.

Despite the pessimistic concerns of economists and politicians, most of the news around the time of the Japanese surrender was upbeat with regards to the reconversion process. Within three days of V-J Day, one reporter wrote "reports indicate that industry is reconverting its plants from war to peace much more quickly and early, and that reconversion unemployment is much smaller than anticipated."[29]

This did not stop the economic forecasters from predicting massive unemployment. Indeed, the faster-than-expected discharge of

[24]Ibid.

[25]*New York Times*, August 28, 1945, p. 38, col. 4.

[26]*New York Times*, September 7, 1945, p. 16, col. 1. The original proposed full employment legislation, however, would have mandated counter-cyclical fiscal policy measures if necessary to obtain full employment. We are indebted to our colleague and Truman scholar Alonzo Hamby for this insight.

[27]*New York Times*, August 28, 1945, p. 1, col. 2. Rep. Harold Knutson repeated his call for a 20 percent individual income tax reduction plus an end to the corporate excess profits tax in late September, to no avail.

[28]*New York Times*, September 2, 1945, p. 10, col. 1.

[29]*New York Times*, September 2, 1945, p. 1, col. 2.

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soldiers led some of them to revise their estimates of unemployment *upward*. For example, on September 1 *Business Week* predicted GNP in 1946 would be 20 percent below the 1944 levels and that unemployment would peak "closer to 9,000,000 than 8,000,000."[30] The 9,000,000 figure represented about 14 percent of the projected civilian labor force.

Businessmen and Wall Street did not listen to the economists. The Standard and Poor Industrial stock index rose more than 30 percent from the fall of 1945 to the fall of 1946. As one commentary put it, "the simple fact is that the transition from war to peace production isn't proving too rough."[31] As early as September 1945, *Business Week* was revising its estimate of unemployment for the end of 1945 down to 4.0 to 4.5 million from 6.0 million.[32] A CED survey of top businessmen predicted relatively high employment levels, with the number of jobs to rise 24 percent above the 1940 level and only 12 percent below the wartime peak.[33]

Still, even in December 1945 economists were predicting that "depression is just around the corner." Robert Nathan predicted six million unemployed by the spring of 1946, implying an unemployment rate of 10 percent.[34] Veteran Department of Labor economist Isidore Lubin decided, in *Business Week*'s opinion, to "play in safe," predicting a wide range; six to nine million unemployed.[35] Even the minimum estimate turned out overly pessimistic by nearly a factor of three.

The Revised Keynesian Interpretation of Reconversion

Yet within a year of the war's end, it was clear that the pessimistic predictions were spectacularly wrong. Accordingly, economists rushed to put a new interpretation on events consistent with the new Keynesian theology that became deeply instilled in many of them. The postwar prosperity (they did not have the benefit of the statistics in the 1990 *Economic Report of the President*) was attributed to pent-up demand. In December 1946, the first report of the newly created Council of Economic Advisers, drafted primarily by Edwin Nourse, was representative of the new interpretation: "We have a postponed consumer demand, enterpriser ambitions, and purchasing

[30]*Business Week*, September 1, 1945, p. 9.
[31]*Business Week*, September 15, 1945, p. 9.
[32]*Business Week*, September 29, 1945, p. 9.
[33]*New York Times*, September 10, 1945, p. 32, col.3 .
[34]*Business Week*, December 27, 1945, p. 10.
[35]Ibid.

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power which hold the potential of some years of great activity . . ."[36]

The view expressed by the Council quickly became enshrined in many cited works published in this period. One of the nation's foremost experts on business cycles, Robert A. Gordon, wrote:

> Even with the decline in government spending, aggregate demand was sufficient to maintain full employment. . . . Consumption increased rapidly in the face of a decline in GNP. Here lies the main part of the answer to the mildness of the reconversion recession.[37]

Alvin Hansen said much the same thing:

> The country came out of the war rich in monetary assets and monetary savings and desperately short of consumers' durables, houses, business plant and equipment. This laid the ground work for a vast postwar prosperity. . . .[38]

The Hansen-Gordon interpretation quickly found itself a part of the standard surveys of American economic history published in the 1950s and later. In the popular second edition of the Harold Williamson-edited textbook on American economic history, Harold Somers noted:

> A striking aspect of the postwar economy was the failure of predictions of postwar depression made by most economists. In general, the effect of deferred demand, financed by accumulated liquid holdings, was underestimated.[39]

The author of the leading selling textbook for many years, Harold Faulkner, echoed this theme, somewhat perceptively, however, giving a bit more emphasis to the investment and export demand dimensions of aggregate demand:

> The "temporary props" for this prosperity were mainly three: business expenditures for reconversion and for new construction and equipment; heavy consumer spending, much of it for commodities unobtainable during the war, and heavy export of goods and services . . .[40]

While modern textbook authors, perhaps bewildered by the contemporary statistics for that era, now play down the postwar recon-

[36]Council of Economic Advisers, *First Annual Report to the President*, 1946, p. 18.

[37]Gordon, *Business Fluctuations*, pp. 465, 467.

[38]*The Postwar American Economy Performance and Problems* (New York: W. W. Norton, 1967), p. 5.

[39]"The Performance of the American Economy Since 1919," in Harold F. Williamson, ed., *The Growth of the American Economy* (Englewood Cliffs, N. J.: Prentice-Hall, 1954), p. 713.

[40]Harold U. Faulkner, *American Economic History*, 7th ed. (New York: Harper, 1954), p. 713.

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version experience, there still seems to be acceptance of the notion that consumers spent America into prosperity. Jonathan Hughes, who sensibly still uses the less-biased 1960 data in analyzing the period, says "consumers now could find something to own: new cars, refrigerators, soft goods. The country went off on a well-earned spending binge."[41] We could find no textbook that explicitly rejected the Hansen-Gordon interpretation.[42]

Thus within a few years of the end of World War II, the orthodox Keynesian demand explanation for the low unemployment during the postwar transition had become enshrined in the literature and in the training of more than a whole generation of economic historians. The postwar experience was cited as further evidence of the efficacy of demand management macroeconomic policies, when in reality overwhelming empirical evidence refuted that very conclusion.[43]

Assessing the Keynesian Interpretation

There are two empirical problems with the "pent-up demand" explanation of the postwar reconversion: timing and magnitude. It is alleged that consumption and investment spending rose dramatically to offset declining government spending, so that aggregate demand was maintained, thereby permitting essentially full employment. Table 4 gives data on some key economic indicators by quarters for the 1945–47 period. By most indicators, the economic decline associated with the postwar reconversion reached its trough no later than the first quarter of 1946. In that quarter, the civilian unemployment rate peaked, while industrial production and nominal GNP reached their lows for the business cycle.

[41]Jonathan R. T. Hughes, *American Economic History*, 3rd ed. (Glenview, Ill: Scott Foresman, 1990), p. 522.

[42]Robert C. Puth, however, shows some skepticism with the data. Using the modern data developed in the mid-1980s, Puth says the 1945 GNP figures "may have substantially overstated the level of economic welfare." See his *American Economic History*, 2nd ed. (Chicago: The Dryden Press, 1988), p. 537. We would also concede that had consumer goods been more readily available in 1946, consumption spending would have been greater, so the demand-side story could have been more factually accurate. The fact remains, however, that high-level consumption spending did not occur, even if the public was willing for it to do so.

[43]As an anonymous referee perceptively pointed out, the adoption of the pent-up demand line of defense meant a theoretical retreat for Keynesians. Previously, the view was that increases in aggregate demand could lead to almost infinite increases in total output (implying a positively sloped aggregate supply curve at all price levels). Implicitly, Keyensians were now accepting the view that consumption spending during World War II had been "crowded out" by increased government spending, and that reduced government spending after 1945 led to a reversal of this process. Of course, proponents of the Keynesian perspective never pointed out this theoretical weakness.

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Keynesian analysis argues that changes in aggregate demand determine the level of both nominal and real economic activity. Using armed forces employment as our measure, military activity peaked in the second quarter of 1945. From that time to the trough of the mild downturn in the first quarter of 1946, government purchases of goods and services fell an extraordinary 67.5 percent, or $65.7 billion.

Table 4
Eight Key American Economic Indicators, Quarterly Data, 1945 I to 1947 IV

Quarter	*Money GNP*[a]	*Unemp. Rate*[b]	*Corp. Profits*[c]	*Ind. Prod.*[d]	*Layoff Rates*[e]	*Average Workwk Manuf.*[f]	*Govt. Purch.*[g]	*Housing Starts*[h]
1945 I	$217.6	1.10%	$10.2	123	0.67	45.4	$98.6	123
II	219.2	1.17	9.6	117	1.23	44.6	97.3	156
III	210.4	2.11	6.9	98	5.57	42.0	80.2	191
IV	206.8	3.66	6.5	86	1.77	41.4	55.2	393
1946 I	197.7	4.14	8.8	84	1.77	40.7	31.6	718
II	205.3	4.02	11.5	87	1.37	40.1	26.2	685
III	215.6	3.66	15.5	93	0.77	40.2	25.5	630
IV	220.7	4.07	18.0	96	0.90	40.5	26.9	625
1947 I	225.1	3.81	18.4	98	0.87	40.5	24.6	702
II	229.3	4.08	17.6	98	1.17	40.2	25.4	747
III	233.6	4.06	17.6	99	0.90	40.1	25.5	912
IV	244.0	3.72	19.3	101	0.87	40.8	26.1	1,007

[a]Seasonally adjusted, in billions.
[b]Civilian unemployment rate, seasonally adjusted.
[c]After-tax corporate profits, in billions, seasonally adjusted.
[d]Industrial production, seasonally adjusted. 1947–1949 = 100.
[e]Layoff rates per 100 workers in manufacturing, not seasonally adjusted.
[f]Average hours worked per week, manufacturing, not seasonally adjusted.
[g]Government purchases of goods and services, not seasonally adjusted, in billions.
[h]Housing starts, in thousands, seasonally adjusted.

Sources: Geoffrey H. Moore, ed., *Business Cycle Indicators* (Princeton: Princeton University Press for the NBER, 1961); GNP: Department of Commerce, *National Income & Product Accounts of the United States* (Washington: Government Printing Office, 1981); Government Purchases: *1949 Statistical Supplement to the Survey of Current Business* (Washington, D.C.: Government Printing Office, 1950).

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Over the same period, consumption spending rose but $14 billion, barely 20 percent of the fall in government spending. Whatever the merits of the "pent-up" demand argument, there was only a modest increase in consumption during the critical period of demobilization and reconversion, to be sure in part because of capacity constraints on consumer goods industries. Investment spending rose a more robust $21.6 billion, and net exports by $9.8 billion, but collectively the increases in demand fell about $20 billion short of decline in government spending, leading money GNP to fall a rather sharp 10 percent.

By the end of the first quarter of 1946, the process of reconversion was largely completed. Nearly seven million persons had left the armed forces, and government spending had fallen well over 90 percent of the way from the wartime peak to what would be the postwar low in 1947. Federal finances had moved from a massive deficit position (equal to 20 percent or more of GNP) to a budget surplus. Monetary policy also moved towards a much more contractionary stance, although monetary growth was still high by long term historical standards. Bank deposits and currency grew slightly over seven percent from the second quarter of 1945 to the first quarter of 1946, less than half the nearly 15 percent growth observed over the preceeding three quarters (the third quarter of 1944 to the second quarter of 1945). The growth in bank reserves similarly declined by about 60 percent.[44]

As the nation moved from a radically expansionary to a contractionary fiscal policy in less than a year, and as it dramatically slowed the extraordinary monetary expansion, did the nation witness what the Keynesian paradigm suggested would happen, and what virtually all economists predicted? No. Unemployment in the first quarter of 1946 averaged slightly over four percent. To be sure that was more than the rate of less than two percent existing in early 1945. Also, even our revised national income statistics would indicate there was some output decline. *Yet the rate of unemployment "peaked" at a rate low by historical norms, below the average of the prosperous 1920s, or the 1950s*. Unemployment was low, long before any "pent up demand" had an opportunity to play a role. Automobile production was still depressed in early 1946, and expenditures on other major consumer goods were still well below normal peacetime, much less abnormally high, levels.

[44]See Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867–1969* (Princeton: Princeton University Press for the National Bureau of Economic Research, 1963), pp. 717–18, 741–42.

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The latter point is empirically verified by the ordinary least squares estimation of simple consumption functions using three data sets for other (presumably "normal") periods, then estimating what consumption should have been for the 1945–47 period assuming the consumption-income relationships of the other periods held. Specifically, we examined annual data for 1929–1941 and for 1948–1970, and quarterly data for the first quarter of 1948 through the fourth quarter of 1959.

The findings are interesting:

(1) All three data sets show that actual consumption did not rise above predicted levels until 1947, well after reconversion was largely over and after the labor market adjustment was completed.

(2) In 1946 consumption spending was still several billion dollars below predicted ("normal") levels by all three data sets. In that connection, in the first quarter of 1946, the personal savings rate (personal savings as a percent of disposable personal income) was still nearly 11 percent, well above historical norms.[45]

(3) The quarterly data suggest that actual consumption rose above "normal" or predicted levels only in the second quarter of 1947, nearly a year after demobilization was essentially completed, a year after real GNP had started to rise, and 19 months into a postwar labor market experience in which the unemployment rate had never exceeded 4.2 percent.

An Alternative Explanation for the Smooth Postwar Conversion

Before the rise of Keynesian economics, most economists believed that what is now termed "cyclical" unemployment resulted from wages in excess of their market-clearing levels. In figure 1, unemployment exists at wage w, and is denoted by the distance between the original demand for labor curve D_1 and the supply for labor curve S_1 at wage w. The observed unemployment can be eliminated in four ways:

(1) a lowering of the money wage from w to w';

(2) an increase in the marginal physical product of labor reflecting a technological advance or other productivity-enhancing development; this would lead the demand curve to shift towards D_2, eliminating unemployment;

(3) an increase in the price of commodities, raising the nominal value of the marginal product of labor, leading to a shift in the

[45]See U. S. Department of Commerce, Bureau of Economic Analysis, *The National Income & Product Accounts of the United States*, 1929–1976, p. 76.

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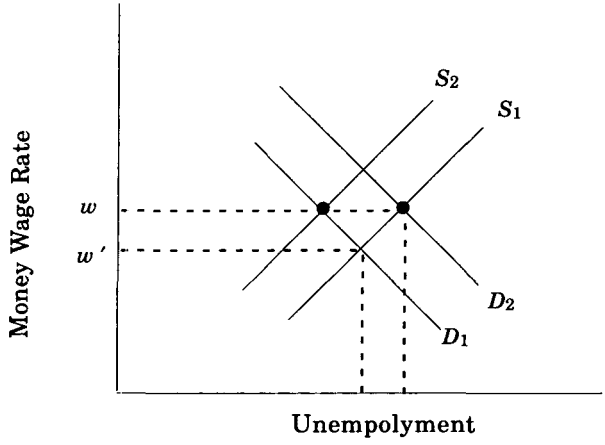

Figure 1. Wage Rates and Unemployment

demand curve; the shift in the demand curve could result from a combination of productivity advance and price increase;

(4) a reduction in labor supply to S_2.

All four of the responses mentioned above impact on equilibrium wage levels, so it is not too much of an exaggeration to state that regarding unemployment, traditional labor market analysis suggests that "wages alone matter." This is in marked contrast to the Keynesian perspective that dominated economic thinking from the 1940s through the 1960s that, with little exaggeration, said that "wages do not matter." A small band of economists, including Ludwig von Mises, F. A. Hayek, Benjamin Anderson and W. H. Hutt, never abandoned the notion that wages are critical in unemployment determination, but these voices carried no weight in the development of the consensus interpetation of why America avoided a depression after World War II.[46]

Yet the empirical evidence, which suggests that "pent up" demand played no meaningful role for nearly two years in which unemployment stabilized at low levels, is consistent with the theory espoused above. This is not to deny that consumers hungered for consumer goods. Nonetheless, in the critical reconversion period, the growth in actual consumption was modest compared with the reduction in federal defense-related spending.

[46]For more on the role of wages in unemployment from the perspective of economic theory, the history of economic thought, and empirical evidence relating to the American experience, see Lowell Gallaway and Richard Vedder, "Wages, Prices and Employment: Von Mises and the Progressives," *Review of Austrian Economics* 1 (1987): 33–80.

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Table 5
Selected Characteristics of the American Labor Force, June 1945 and June 1946

Labor Force Characteristic	*June 1945*[a]	*June 1946*[a]
Non-Institutional Population[b]	105,290	106,210
Total Labor Force	67,590	62,000
Total Employment	66,700	59,430
Federal Employment	15,849	5,879
Armed Forces	12,130	3,070
Civilian	3,719	2,809
Non-Federal Employment	50,851	53,551
Civilian Employment	54,570	56,360
Male	34,710	39,650
Female	19,860	16,710
Female Civilian Employment as % of Total	36.39%	29.65%
Unemployment	890	2,570
Male	460	2,010
Female	430	560
Unemployment Rate (% of Civilian Labor Force)	1.60%	4.36%
Unemployment Rate (% of Total Labor Force)	1.32%	4.15%
Labor Force Participation Rate	64.19%	58.37%
Employment-Population Ratio	63.35%	55.96%

[a]Age 14 or over.
[b]In thousands.

Sources: *1949 Statistical Supplement: Survey of Current Business*, p. 53; *Monthly Labor Review* (August and September 1946).

To begin our look at this evidence, it is interesting to compare labor force statistics at the height of mobilization, June 1945, with statistics just exactly one year later, June 1946 (see table 5).

The total labor pool grew by nearly one million over the year, yet the labor force fell by nearly 5.6 million. The end of the war was accompanied by an enormous drop in the labor force participation rate. In particular, millions of women voluntarily decided to withdraw from the labor force and reverted to their traditional roles as mothers, wives, and housekeepers. About 56 percent of the potential unemployment created by the almost 10 million decline in federal

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employment was absorbed by voluntary exit from the labor force.

The word "voluntary" in the preceeding paragraph is important. It is presumed in a free society that labor voluntarily enters into labor market decisions. Yet during World War II, millions of men were drafted and became part of the labor force; some of them may have not voluntarily been part of that labor force in the absence of conscription. Thus the wartime unemployment rates of under two percent were low, at least in part, because the normal rules of non-coercive labor market participation did not apply. Thus the postwar rise in the reported unemployment rate, modest as it was, still overstated the true recessionary conditions that existed.

Yet the sudden reversion of labor supply to more normal levels was not the only factor in the moderate postwar unemployment. Non-federal employment grew 2.7 million in this first postwar year, in a period before the major consumer goods industries had resumed full production. Indeed, factory employment in June 1946 was still more than 10 percent below the June 1945 levels (because of declining defense-related production), implying the job growth in non-manufacturing, non-federal employment was actually more than four million jobs. More than 27 percent of the problem that the release of 10 million government employees created was eliminated by increased civilian employment, most of it in the private sector. If defense industries are considered, demobilization from June 1945 to June 1946 meant the loss of over 11 million jobs, about four million of which (about 36 percent) were absorbed in the civilian economy.

Why was non-manufacturing civilian employment soaring by over 10 percent in one year, particularly when one considers that economists were widely predicting a resumption of the Great Depression of the 1930s, and when one considers that the mainline durable goods industries (which were in manufacturing in any case) were still at below normal production? How could millions of new civilian jobs be created when there was "underconsumption" by normal standards?

The answer lies, we think, in the other forms of unemployment-determining labor market adjustments discussed above: changes in money wages, prices, and the productivity of labor. The money wage divided by prices is called typically the "real wage." Real wages adjusted (by division) to take account of productivity changes can thus be called the "adjusted real wage." It is our contention that, in addition to reduced labor supply, a decline in the adjusted real wage helped absorb the more than 11 million workers released in the first year of the demobilization.

Directly calculating what happened to the adjusted real wages is

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difficult for a variety of reasons. There is no accepted data series giving hourly wages for the entire labor force before 1947. Annual earnings figures are of questionable value because of a major reduction in overtime work at the conclusion of the war. Regarding prices, the deficiencies of price indices, particularly in a period when price controls are changing, are well known. Similarly, deficiencies in price indices impact on the calculation of labor productivity.

Nonetheless, we calculated the adjusted real wage for labor some 18 different ways, using three different measures of hourly wages, three different price indices, and two different estimates of changing labor productivity. Specifically, we used hourly earnings in manufacturing, retail trade, and contract construction for our money wage measure, and the consumer price index, wholesale price index, and GNP price deflator in calculating real wages, and real private gross domestic product per man-hour, and real private gross domestic product per unit of labor input as our measure of labor productivity.[47]

The calculations reveal that for 1946, some 14 of 18 estimates show a decline in the adjusted real wage from 1945 levels, with the median decline being 2.35 percent. In no case was there an estimated increase in the adjusted real wage of greater than two percent. Similarly, making calculations for 1947 reveals even more striking results. Some 17 of 18 estimates of the adjusted real wage for 1947 are below 1945 levels (the single exception showed a 0.5 percent increase), with the median estimate recording a decline of 7.15 percent. Using the median, it would appear the adjusted real wage tended to fall some in 1946, and continued to fall in 1947, perhaps explaining the continued robust growth in employment that year.

Elsewhere we have argued that New Deal "underconsumptionist" reasoning led to wage-enhancing legislation that prolonged the Great Depression of the 1930s.[48] Some dimensions of reconversion served to reduce (although not eliminate) some deleterious unemployment effects of the New Deal legislative initiatives. For example, the peacetime transition meant a fall in the average work week, as weary wartime workers sought an increase in leisure time. With a fall in the length of the average workweek came a decline, other things equal, in money wages. Suppose a worker making one dollar per hour worked a 45 hour week in early 1945. Because of the Fair Labor Standards Act of 1938, the worker received $1.50 per hour for hours worked past 40, or a total

[47]The *Historical Statistics of the United States, Colonial Times to 1975* was used in the calculations. With that source, the price distortions with respect to the GNP price deflator were modest compared with later revisions.

[48]Gallaway and Vedder, "Wages, Prices and Employment."

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of $47.50 for a 45 hour week, slightly over $1.05 in average hourly pay. A reduction in hours to 40, the nominal hourly wage left unchanged, lowered the paycheck to $40 ($1.00 per hour), a decline in over 5 percent in the average hourly wage. This example was a common occurrence.

Another development, unrealized at the time, was the relative decline in the importance of labor unions in the economy. Labor union membership as a percent of civilian employment reached a peak in 1945 and declined after the war (and has continued to decline ever since). For example, in 1945, union membership equalled 26.59 percent of the civilian labor force; in 1946, the proportion had fallen fairly noticeably, to 25.03 percent, and then to 24.58 percent in 1947.[49] The decline occurred despite a rise in the proportion of workers who were male (more inclined to unionize). The decline in relative union importance reduced somewhat the pressures on wage levels that collective bargaining imposes.

At least two factors contributed to the relative decline in union strength. First, the shift in employment from the relatively union-intensive manufacturing sector to the less unionized service sector was a major factor. Even within manufacturing, however, the demise in the War Labor Board after late 1945 removed a pro-union form of governmental intervention. The WLB consistently promoted collective bargaining in war plants and the end of the war brought a close to this activity.

Because of the data problems mentioned earlier in the paper, however, we have only limited faith in the estimates of falling adjusted real wages given above. Fortunately there is an alternative way of discerning the change in adjusted real wages that avoids some of the problems associated with using price indices, etc. When the same price index is used in calculating real wages is utilized in determining what happened to labor productivity, it turns out that the adjusted real wage is simply equal to money wage payments divided by total output or, more appropriately, personal income.

Specifically, real wages are equal to hourly money wages (w) divided by some price index (P), or w/P. Similarly, labor productivity equals money output per hour (O) divided by a price index, or O/P. Assuming the same price index in both calculations, dividing w/P by O/P gives w/O. The latter variable is simply labor compensation as a proportion of GNP or, using distributive shares data, personal income.

[49]Total labor union membership in U.S. unions rose but 77,000 in 1946, even as non-agricultural employment grew by nearly 2.7 million workers. See the *Historical Statistics of the United States, Colonial Times to 1957*, pp. 126 and 178.

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Table 6
Compensation as a Percent of GNP and Personal Income, 1945 to 1947

Quarter	*Employee Compensation**	*Personal Income**	*Money GNP**	*Compensation as % of:* *Personal Income*	*GNP*
1945 I	$122.5	$174.4	$222.6	70.2%	55.0%
II	121.6	174.2	225.0	69.8	54.0
III	117.4	170.7	213.0	68.8	55.1
IV	109.1	168.6	200.3	64.7	54.5
1946 I	105.1	168.5	199.1	62.4	52.8
II	109.8	173.5	206.3	63.3	53.2
III	114.0	181.4	221.1	62.8	51.6
IV	116.7	183.8	224.0	63.5	52.1
1947 I	118.5	187.8	228.2	63.1	51.9
II	119.8	187.6	233.6	63.9	51.3
III	123.1	196.6	232.4	62.6	53.0
IV	127.7	201.7	248.6	63.3	51.4

*In billions of dollars.

Sources: *1949 Statistical Supplement, Survey of Current Business* (Washington, D.C.: Government Printing Office, 1950), pp. 6, 7; authors' calculations. GNP statistics differ from those used elsewhere in the paper because of more recent revisions; data for 1945 are not available in those revisions.

Table 6 gives data on employee compensation, personal income and gross national product by quarters. Note that the ratio of employee compensation to income or output falls after the conclusion of the war. Using labor's share of personal income, the decline is from the 69–70 percent level late in the war to about 63 percent in the 1946 and 1947 quarters. Using labor's share of GNP, the decline is from 54–55 percent in the late war (first three quarters of 1945) to 51–53 percent in the 1946 and 1947 quarters. However calculated, labor's share declined, meaning the aggregate adjusted real wage tended to fall. These findings thus are consistent with the results suggested by wage, price, and productivity data. Millions of workers were hired by business despite an uncertain economic future in large part because "the price was right."

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The fall in the adjusted real wage meant an increase in remuneration of capital. After-tax corporate profits, never much over $11 billion on an annualized basis during the war, rose to about $18 billion (on an annual basis) by the last quarter of 1946.[50]

Nominal interest rates remained extremely low, increasing the spread between anticipated return on invested capital and the cost of borrowed funds. For example, the average interest yield on a triple-A (Moody's) corporate bond in 1946 was 2.53 percent, the lowest of any year since that statistic has been kept.[51] A major factor in the low interest rates, despite a relative tightening in monetary policy, was the government budget surplus that developed in 1946. The federal government, in effect, moved from being a supplier rather than a demander in the loanable funds market. Perhaps the most massive move towards a contractionary (in a Keynesian perspective) fiscal policy in the nation's history helped to create conditions in capital and money markets that assisted in the transition. The postwar era was a classic case of "reverse crowding out." Rising profits, and the anticipation of future increases, stimulated investment spending (the only truly robust major component of aggregate demand).

Rising profits led to rising equity values and higher net worths. Raymond Goldsmith estimates the national wealth rose far more in the two years from 1945 to 1947 (46.4 percent) than in the 16 years from 1929 to 1945 (31.1 percent).[52] Whereas the anti-capitalistic innovations of the New Deal probably caused what was in real terms a *decline* in national wealth in the 1929–45 era, the modest but real retreat from interventionism along with a fall in the adjusted real wage and the associated rise in returns to capital led to a significant growth in wealth in the demobilization period.

An excellent case can be made, indeed, that the increase in autonomous consumption in the post-war era reflected increased spending *induced by rising wealth*. About two-thirds of the shift in autonomous consumption from 1945 to 1947 can be explained by the $267 billion growth in national wealth during that period, if one accepts the Ando and Modigliani view that the marginal propensity to consume out of wealth is about .06.[53]

[50]The exact profit figure depends on whether the data are seasonally adjusted, take into account inventory evaluation adjustments, taxes, etc. See the *1949 Statistical Supplement to the Survey of Current Business* (Washington, D.C.: Government Printing Office, 1948), p. 6.

[51]*Historical Statistics of the United States, Colonial Times to 1975*, p. 1003.

[52]Ibid, p. 255.

[53]Albert Ando and Franco Modligliani, "The 'Life Cycle' Hypothesis of Savings: Aggregate Implications and Tests," *American Economic Review* 53 (March 1963): 55–84.

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In short, rather than "pent-up demand" preventing a depression, the evidence is more consistent with a distinctly non-Keynesian interpretation: A downward adjustment in labor supply and real wages, accompanied by a more responsible (non-deficit) fiscal policy, served to stimulate investment and consumption spending. Relative price adjustments brought about what Keyensians perceived to be an increase in aggregate demand, rather than the other way around.

Conclusions

Modern standard statistical sources suggest there was a very severe economic downturn in 1946. The evidence does not support that conclusion, and it is clear that statistical revisions have served to distort the historical experience. Keynesian economists *ex ante* predicted a major downturn after the war, but when it did not come they *ex post* abruptly changed their tune and argued that a surge in private spending, especially consumption and investment spending, prevented a downturn.

The evidence shows that aggregate demand rose too little and too late to explain the low unemployment that prevailed in the first two years after V-J day, the period in which demobilization was completed. What did happen was that labor markets, partially constrained by non-price factors in the wartime period, were allowed to function in a manner that prevented a serious decline. Labor supply abruptly fell, but in addition real wages, adjusted for productivity change, also fell, preventing a massive rise in unemployment.

To the extent aggregate demand was stimulated at all, it was because of the relative price changes outlined above. Lower adjusted real wages meant higher profits and rates of return on investment spending. A dramatic shift in governmental demand for loanable funds, far from contracting the economy as Keynesian economics suggests, kept interest rates at historic lows. Rising wealth associated with the high returns on capital led to increased consumption that ultimately led to a durable goods explosion—but one that took place long after reconversion had occurred without any major unemployment.

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Appendix

Estimating the GNP Price Deflator and Real GNP

A model was constructed using real and monetary variables that provided a close statistical fit to the real GNP price deflator for the largely non-price control years 1916 to 1941; the model was estimated by ordinary least squares regression analysis using annual data:

$$\begin{aligned}(1)\ \text{DEFLATOR} &= \underset{(1.190)}{26.895} + \underset{(1.573)}{0.326}\ \text{M2} + \underset{(3.776)}{2.717}\ \text{CPAPER} \\ &\quad - \underset{(0.093)}{0.000}\ \text{TONMIL} - \underset{(0.012)}{0.000}\ \text{EMPLOY}\end{aligned}$$

$$R^2 = .822,\ \text{D-W} = 1.715,\ F = 18.521,$$

where DEFLATOR refers to the GNP price deflator, M2 to that definition of money, CPAPER to the interest rate on commercial paper, TONMIL to the ton-miles of freight hauled by class A railroads, and EMPLOY to the number of employed persons; an autoregressive term is omitted, and numbers in parentheses are *t*-values.[54] The 1942–47 deflator was estimated from (1).

Econometrically Evaluating the "Pent-Up Demand" Argument

A simple bivariate Keynesian consumption function was statistically fitted, where the dependent variable was CONSUMPTION and the independent variable DISINC, for disposable income. Annual data were obtained from *Historical Statistics* (1975 Edition) for the years 1929 to 1941, and from the same source for 1948 to 1970. In addition, quarterly data for the years 1948 through 1959 were obtained from *The National Income & Product Accounts of the United States, 1929–1976*. The obtained statistical results follow:

$$\begin{aligned}&1948\text{-}70 : \text{CONSUMPTION} = \underset{(4.932)}{7.570} + \underset{(235.706)}{0.891}\ \text{DISINC}, \bar{R}^2 = .9996, \\ &\qquad\qquad\qquad\qquad\qquad\qquad\qquad\qquad\qquad\qquad\qquad\qquad \text{D-W} = 1.983; \\ &1929\text{-}41 : \text{CONSUMPTION} = \underset{(1.882)}{3.874} + \underset{(29.602)}{0.898}\ \text{DISINC}, \bar{R}^2 = .9865, \\ &\qquad\qquad\qquad\qquad\qquad\qquad\qquad\qquad\qquad\qquad\qquad\qquad \text{D-W} = 1.124; \\ &1948\text{-}59 : \text{CONSUMPTION} = \underset{(4.809)}{9.819} + \underset{(112.864)}{0.880}\ \text{DISINC}, \bar{R}^2 = .9963, \\ &\text{Quarterly} \qquad\qquad\qquad\qquad\qquad\qquad\qquad\qquad\qquad\qquad \text{D-W} = 1.954.\end{aligned}$$

[54]All data were obtained from *Historical Statistics of the United States, Colonial Times to 1975.*

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Actual vs. predicted values for 1945–47 using annual data (all dollar numbers in billions) were:

		Predicted Values:	
Year	*Actual Value*	*48-70 DATA*	*29-41 DATA*
1945	$119.6	$140.5	$137.9
1946	143.9	149.1	146.6
1947	161.9	158.0	155.5

Using quarterly data for 1948–59, the predicted values for 1946–47 (all dollar numbers in billions) were:

Quarter	*Actual Consumption*	*Predicted Consumption*
1946 I	$134.5	$144.5
II	139.6	147.3
III	148.4	152.2
IV	152.7	155.2
1947 I	154.0	155.8
II	159.0	154.0
III	163.5	160.3
IV	167.6	162.4

Postwar consumption did not exceed "normal" levels in relation to disposable income until well into 1947—two years after peak mobilization.

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Ludwig von Mises and the Austrian School of Economics

Jeffrey M. Herbener*

> Everyone carries a part of society on his shoulders: no one is relieved of his share of responsibility by others. And no one can find a safe way for himself if society is sweeping towards destruction. Therefore everyone, in his own interests, must thrust himself vigorously into the intellectual battle. No one can stand aside with unconcern: the interests of everyone hang on the result. Whether he chooses or not, every man is drawn into the great historical struggle, the decisive battle into which our epoch has plunged us (Mises 1988, p. 169).

This is the message of Ludwig von Mises. No one has ever fought the battle more courageously than Mises, nor had a more decisive long-run effect. Murray Rothbard is correct when he says ". . . if the world is ever to get out of its miasma of statism, or, indeed, if the economics profession is ever to return to a sound and correct development of economic analysis, both will have to abandon their contemporary bog and move to that high ground that Mises developed for us" (Rothbard 1983, p. 5).

Now, as the battle appears to be turning in favor of freedom, is an appropriate time to reconsider the role of economic theory in these world-wide changes. Specifically, it is time to consider the work of Mises and the Austrian school in the development and dissemination of the economic principles of social progress. Two steps are necessary to complete this task. The first is to demonstrate the pre-eminence of the Austrian school in developing the principles of free enterprise. The second is to demonstrate that Mises is the champion of this tradition in the twentieth century.

*Jeffrey M. Herbener is assistant professor of economics at Washington and Jefferson College in Pennsylvania.

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Method and the Austrian Tradition

Carl Menger founded the Austrian school during the marginalist revolution of the late nineteenth century in his attempt to correct the errors of the classical economists. As Menger said:

> Adam Smith and this school have neglected to reduce the complicated phenomena of human economy in general, and in particular of its social form, "national economy" to the efforts of individual economies, as would be in accordance with the real state of affairs. They have neglected to teach us to understand them theoretically as the result of individual efforts. Their endeavors have been aimed, rather, and to be sure, subconsciously for the most part, at making us understand them theoretically from the point of view of the "national economy" fiction. On the other hand, the historical school of German economists follows this erroneous conception consciously (Menger 1985, pp. 195–96).

It is the adherence to these methodological precepts of individualism and essentialism that distinguish the Austrian school from all others. Although Mises significantly refined and improved his position, Menger laid the groundwork:

> This is the ground on which I stand. In what follows I have endeavored to reduce the complex phenomena of human economic activity to the simplest elements that can still be subjected to accurate observation, to apply to these elements the measure corresponding to their nature, and constantly adhering to this measure, to investigate the manner in which the more complex economic phenomena evolve from their elements according to definite principles (Menger 1976, p. 47).
>
> It is now the task of the reader to judge to what results the method of investigation I have adopted has led, and whether I have been able to demonstrate successfully that the phenomena of economic life, like those of nature, are orderly strictly in accordance with definite laws (Menger 1976, p. 48).

Via this method, Menger solved the paradox of value, derived the subjective theory of value, developed a unified theory of price and reconstructed the origin of social institutions such as money, markets, property, and law. More than this, he began the process, culminating in the work of Mises, that has resulted in universally correct economic laws of social systems. As Menger stated:

> The aim of this orientation, which in the future we will call the *exact* one, an aim which research pursues in the same way in all realms of the world of phenomena, is the determination of strict laws of phenomena, of regularities in the succession of phenomena which do not present themselves to us as absolute, but which in respect to the approaches to cognition by which we attain to them simply bear within themselves the guarantee of absoluteness (Menger 1985, p. 59).

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In contrast, most other schools of economic thought deny, because of their methodological positions, the existence of universal laws of economics. Most prevalent are empirically based schools such as the German historical school that Menger fought. Menger was quite clear on this:

> If, therefore, exact laws are at all attainable, it is clear that these cannot be obtained from the point of view of empirical realism, but only in this way, with theoretical research satisfying the presuppositions of the above rule of cognition.
>
> But the way by which theoretical research arrived at the above goal, a way essentially different from Bacon's empirical-realistic induction, is the following: it seeks to ascertain the *simplest elements* of everything real, elements which must be thought of as strictly typical just because they are the simplest.
>
> The specific goal of this orientation of theoretical research is the determination of regularities in the relationships of phenomena which are guaranteed to be absolute and as such to be complete.
>
> It examines, rather, how more complicated phenomena develop from the simplest, in part even unempirical elements of the real world in their (likewise unempirical) isolation from all other influences . . .
>
> Science starts out, however, with these assumptions, since it would never be able otherwise to reach the goal of exact research, the determination of strict laws. On the other hand, with the assumption of strictly typical elements, of their exact measure, and of their complete isolation from all other causative factors, it does to be sure, and indeed on the basis of the rules of cognition characterized by us above, arrive at laws of phenomena which are not only absolute, but according to our laws of thinking simply cannot be thought of in any other way but as absolute (Menger 1985, pp. 60–61).

Menger, like Mises, leaves no doubt regarding his view of the efficacy of empirically testing economic theory; providing a refutation of positivism and falsification in economics almost a century before Milton Friedman and F. A. Hayek espoused them.

> Among economists the opinion often prevails that the empirical laws, "because they are based on experience," offer better guarantees of truth than those results of exact research which are obtained, as is assumed, only deductively from a priori axioms.
>
> The error at the basis of this view is caused by the failure to recognize the nature of the exact orientation of theoretical research, of its relationship to the realistic, and by applying the points of view of the latter to the former.
>
> Nothing is so certain as that the results of the exact orientation of

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> theoretical research appear insufficient and unempirical in the field of economy just as in all the other realms of the world of phenomena, when measured by the standard of realism. This is, however, self-evident, since the results of exact research, and indeed in all realms of the world of phenomena, are true only with certain presuppositions, with presuppositions which in reality do not always apply. Testing exact theory of economy by the full empirical method is simply a methodological absurdity, a failure to recognize the bases and presuppositions of exact research. At the same time it is a failure to recognize the particular aims which the exact sciences serve. To want to test the pure theory of economy by experience in its full reality is a process analogous to that of the mathematician who wants to correct the principles of geometry by measuring real objects, without reflecting that the latter are indeed not identical with the magnitudes which pure geometry presumes or that every measurement of necessity implies elements of inexactitude. Realism in theoretical research is not something higher than exact orientation, but something different.
>
> The results of realistic orientation stand in an essentially different relationship to the empirical method than those of exact research. The former are based, of course, on the observation of phenomena in their "empirical reality" and complexity, and of course the criterion of their truth is accordingly the empirical method. An empirical law lacks the guarantee of absolute validity a priori, i.e., simply according to its methodological presuppositions. It states certain regularities in the succession and coexistence of phenomena which are by no means necessarily absolute. But bearing this firmly in mind, we note that it must agree with full empirical reality, from the consideration of which it was obtained. To want to transfer this principle to the results of exact research is, however, an absurdity, a failure to recognize the important difference between exact and realistic research. To combat this is the chief task of the preceding investigations (Menger 1985, pp. 69–70).

While referring to the German historical school, Menger also refuted the modern hermeneutic economists.

> There is scarcely any need to remark that the nature and significance of the exact orientation of research is completely misunderstood in the modern literature on national economy. In German economics, at least in the historical school, the art of abstract thinking, no matter how greatly distinguished by depth and originality and no matter how broadly supported empirically—in brief, everything that in other theoretical sciences establishes the greatest fame of scholars is still considered, along with the products of compilatory diligence, as something secondary, almost as a stigma. The power of truth, however, will finally also be tested for those who, sensing their inability to solve the highest problems of the social sciences, would like to raise their own inadequacy as a standard for the value of scientific work in general (Menger 1985, p. 65).

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Neither Hayek, who has come to accept the empirical method of Karl Popper, nor the modern hermeneuticians who advance the epistemology of subjective interpretation, have any grounding in Menger. Only Mises has accepted Menger's basic deductive procedure and forged ahead to refine it into praxeology. Mises is the true heir of the Austrian tradition and the person who has advanced the edifice of absolute economic laws in this century.

Hayek versus Menger

As Hayek progressively left his grounding in the praxeological method, he drifted further and further into error. This process has culminated in Hayek's latest work on socialism which he claims is based on Menger:

> But to me, at any rate, [*Investigations*'] main interest to the economist in our days seems to lie in the extraordinary insight into the nature of social phenomena which is revealed incidentally in the discussion of problems mentioned to exemplify different methods of approach . . . Discussions of somewhat obsolete views, as that of the organic or perhaps better physiological interpretation of social phenomena, gave him an opportunity for an elucidation of the origin and character of social institutions which might, with advantage, be read by present-day economists and sociologists (Hayek 1976, p. 23).

> Menger was the only one of these to have come after Darwin, yet all attempted to provide a rational reconstruction, conjectural history, or evolutionary account of the emergence of cultural institutions (Hayek 1988, p. 70).

> Adequate explanations of [the market, etc.] were disseminated . . . especially by the Austrian school following Menger, into what became known as the "subjective" or "marginal utility" revolution in economic theory. [The most elementary and important] was the discovery that economic events could not be explained by preceding events acting as determining causes that enabled these revolutionary thinkers to unify economic theory into a coherent system (Hayek 1988, p. 97).

What Menger wrote about using organic analogies in the social sciences in no way justifies Hayek's claim. Menger stated clearly that the analysis of social development must be built from individual action and that reason is the guiding force in understanding social processes.

> In [the organic] category belong above all the attempts of those who think that they have solved the problem involved merely by designating as "organic" the developmental process we are discussing. The process by which social structures originate without action of the common will may well be called "organic," but it must not be believed

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> that even the smallest part of the noteworthy problem of the social sciences that we alluded to above has been solved by this image or by any mystic allusions attached to it (Menger 1985, p. 149).

Yet Hayek makes just such allusions when he claims that the spontaneous order of the market "forms itself" or:

> The answer to [how we came to acquire the economic order of the market] is built upon the old insight, well known to economics, that our values and institutions are determined not simply by preceding causes but as part of a process of unconscious self-organisation of a structure or pattern. This is true not only of economics, but in a wide area, and is well known today in the biological sciences (Hayek 1988, p. 9).

Menger sees two mistakes made in the analysis of social processes: the mystic one mentioned above, and the view that society is a product of the "common will," i.e., created by positive legislation.

> Just as meaningless is another attempt to solve the problem discussed here. I mean the theory, which has attained widespread currency, that recognizes in social institutions something *original*, that is, not something that has developed, but an *original* product of the life of the people. This theory (which, incidentally, is also applied by a few of its adherents, for whom a unified principle means more than historical truth or the logic of things, by way of a peculiar mysticism to social institutions created by positive laws) indeed avoids the error of those who reduce all institutions to acts of positive common will. Still, it obviously offers us no solution of the problem discussed here, but evades it. The origin of a phenomena is by no means explained by the assertion that it *was present from the very beginning* or that it *developed originally* (Menger 1985, p. 149).

But Hayek is reduced to such a conclusion, "Although also acclaimed as a biologist, Aristotle lacked any perception of two crucial aspects of the formation of any complex structure, namely, evolution and the self-formation of order" (Hayek 1988, p. 45). Appeals to words like evolution or self-formation are not solutions to the problems of the origin and development of social institutions. Menger clearly looked to individual action as the foundation of the solution.

> Such a phenomenon must obviously have developed at some time from its simpler elements; a social phenomenon, at least in its most original form, must clearly have developed from individual factors. The view here referred to is merely an analogy between the development of social institutions and that of natural organisms which is completely worthless for the purpose of solving our problem. It states, to be sure, that institutions are unintended creations of the human mind, but not *how* they came about. These attempts at interpretation are comparable to the procedure of a natural scientist who thinks he is solving the problem of the origin of natural organisms by alluding

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to their "originality," "natural growth," or their "primeval nature" (Menger 1985, p. 149).

In contrast, Hayek approvingly quotes Popper, who stated, "Cultural evolution continues genetic evolution by other means" (Hayek 1988, p. 16). He continues:

> For example, by the time culture began to displace some innate modes of behavior, genetic evolution had probably also already endowed human individuals with a great variety of characteristics which were better adjusted to the many different environmental niches into which men had penetrated than those of any non-domesticated animal. . . . Among the most important of these innate characteristics which helped to displace other instincts was a great capacity for learning from one's fellows, especially by imitation (Hayek 1988, p. 18).

Menger pointed out the poverty of this line of argument:

> The previous attempts to interpret the *changes* of social phenomena as "organic processes" are no less inadmissible than the above theories which aim to solve "organically" the problem of the *origin* of unintentionally created social structures. There is hardly need to remark that the changes of social phenomena cannot be interpreted in a social-pragmatic way, insofar as they are not the intended result of the agreement of members of society or of positive legislation, but are the unintended product of social development. But it is just as obvious that not even the slightest insight into the nature and the laws of the movement of social phenomena can be gained either by the mere allusion to the "organic" or the "primeval" character of the processes under discussion, nor even by mere analogies between these and the transformations to be observed in natural organisms. The worthlessness of the above orientation of research is so clear that we do not care to add anything to what we have already said (Menger 1985, p. 150).

Hayek bases his analysis on exactly these allusions and analogies:

> Despite such differences, all evolution, cultural as well as biological, is a process of continuous adaptation to unforeseeable events, to contingent circumstances which could not have been forecast (Hayek 1988, p. 25).

> Economics has from its origins been concerned with how an extended order of human interaction comes into existence through a process of variation, winnowing and sifting far surpassing our vision or our capacity to design. . . . We are led—for example by the pricing system in market exchange—to do things by circumstances of which we are largely unaware and which produce results that we do not intend (Hayek 1988, p. 14).

Menger rejected these mystic forces and Hayek's characterization

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of individuals as mindless, passive, and ignorant:

> If this significant problem of the social sciences is truly to be solved, this cannot be done by way of superficial and, for the most part, inadmissable analogies. It can be done, in any case, only by way of direct consideration of social phenomena, not "organically," "anatomically," or "physiologically," but only in a *specifically sociological* way. The road to this, however, is *theoretical* social research, the nature and main orientations of which (the exact and the empirical-realistic) we have characterized above (Menger 1985, p. 150).

Hayek relies upon evolution to explain language, law, morals, markets, and money (Hayek 1988, p. 24); in contrast Menger claims that these institutions can be understood as built upon individual action.

> [These are] the unintended result of innumerable efforts of economic subjects pursuing *individual* interests. The theoretical understanding of them, the theoretical understanding of their nature and their movement can thus be attained in an exact measure only in the same way as the understanding of the above mentioned social structures. That is, it can be attained by reducing them to their elements, to the *individual* factors of their causation, and by investigating the laws by which the complicated phenomena of human economy under discussion here are built up from these elements. This, however, as scarcely needs saying, is that method which we have characterized above as the one adequate for the exact orientation of theoretical research in the realm of social phenomena in general. The methods for the exact understanding of the origin of the "organically" created social structures and those for the solution of the main problems of exact economics are by nature identical (Menger 1985, pp. 158–59).

Hayek versus Mises

Menger began to build the principles of economics from what he saw as the essence of these individual factors—the human need to satisfy material ends. From this idea of subjective value, he proceeded to derive principles of action of an isolated individual, then the more complex principles; two-person exchange (based upon mutual benefit), the social division of labor, and finally, a consistent, unified theory of price (see Menger 1976). These principles were the basis of his advocacy of laissez faire (see Rothbard 1991).

Eugen von Böhm-Bawerk, accepting Menger's methodological position, constructed the theories of advanced social production, capital and interest, and demolished the underpinnings of Marxian economics (Böhm-Bawerk 1959).

Refining and building upon this work, Mises constructed a very different picture of society's origin and development from that of Hayek (Salerno 1990). His answer to a Hayekian view of society is:

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> To those pretending that man would be happier if he were to renounce the use of reason and try to let himself be guided by intuition and instincts only, no other answer can be given than an analysis of the achievements of human society. In describing the genesis and working of social cooperation, economics provides all the information required for an ultimate decision between reason and unreason. If man reconsiders freeing himself from the supremacy of reason, he must know what he will have to forsake (Mises 1966, p. 91).

Mises saw society as a strategy of acting individuals in their struggle against scarcity; purposefulness is the essence of the market, not spontaneity.

> Seen from the point of view of the individual, society is the great means for the attainment of all his ends (Mises 1966, p. 165).

> Society is concerted action, cooperation. Society is the outcome of conscious and purposeful behavior. This does not mean that individuals have concluded contracts by virtue of which they have founded human society. The actions which have brought about social cooperation and daily bring it about anew do not aim at anything else than cooperation and coadjuvancy with others for the attainment of definite singular ends. The total complex of the mutual relations created by such concerted actions is called society (Mises 1966, p. 143).

For Mises the division of labor (which is predicated on the inherent differences in individuals and natural resources) is the essence of society and the linchpin of all aspects of civilization.

> Society is division of labor and combination of labor (Mises 1966, p. 143).

> The fundamental social phenomenon is the division of labor and its counterpart human cooperation (Mises 1966, p. 157).

> The fundamental facts that brought about cooperation, society, and civilization and transformed the animal man into a human being are the facts that work performed under the division of labor is more productive than isolated work and that man's reason is capable of recognizing this truth. But for these facts men would have forever remained deadly foes of one another, irreconcilable rivals in their endeavors to secure a portion of the scarce supply of means of sustenance provided by nature (Mises 1966, p. 144).

> The law of association makes us comprehend the tendencies which resulted in the progressive intensification of human cooperation. We conceive what incentive induced people not to consider themselves simply as rivals in a struggle for the appropriation of the limited supply of means of subsistence made available by nature. We realize what has impelled them and permanently impels them to consort with one another for the sake of cooperation. Every step forward on the way to a more developed mode of the division of labor serves the

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> interests of all participants. In order to comprehend why man did not remain solitary, searching like the animals for food and shelter for himself only and at most also for his consort and his helpless infants, we do not need to have recourse to a miraculous interference of the Deity or to the empty hypostasis of an innate urge toward association. Neither are we forced to assume that the isolated individuals or primitive hordes one day pledged themselves by a contract to establish social bonds. The factor that brought about primitive society and daily works toward its progressive intensification is human action that is animated by the insight into the higher productivity of labor achieved under the division of labor (Mises 1966, p. 160).

The degree to which individuals extend and intensify the division of labor depends on their understanding and acceptance of it. In contrast to Hayek, who says, "The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design" (Hayek 1988, p. 76), Mises attached an important role to teaching people economic principles and persuading them to pursue their "rightly understood interests."

> The principle of the division of labor is one of the great basic principles of cosmic becoming and evolutionary change. The biologists were right in borrowing the concept of the division of labor from social philosophy and in adapting it to their field of investigation . . . But one must never forget that the characteristic feature of human society is purposeful cooperation; society is an outcome of human action, i.e., of a conscious aiming at the attainment of ends. No such element is present, as far as we can ascertain, in the processes which have resulted in the emergence of the structure-function systems of plant and animal bodies and in the operation of the societies of ants, bees, and hornets. Human society is an intellectual and spiritual phenomenon. It is the outcome of a purposeful utilization of a universal law determining cosmic becoming, viz., the higher productivity of the division of labor. As with every instance of action, the recognition of the laws of nature is put into the service of man's efforts to improve his conditions (Mises 1966, p. 145).

> The body of economic knowledge is an essential element in the structure of human civilization; it is the foundation upon which modern industrialism and all the moral, intellectual, technological, and therapeutical achievements of the last centuries have been built. It rests with men whether they will make the proper use of the rich treasure with which this knowledge provides them or whether they will leave it unused. But if they fail to take the best advantage of it and disregard its teachings and warnings, they will not annul economics; they will stamp out society and the human race (Mises 1966, p. 885).

The prerequisite for advanced social production is calculation that allows purposeful action within the framework of the division of

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labor. Calculation requires money prices and thus, money and free exchange, which requires private property.

> Economic calculation is the fundamental issue in the comprehension of all problems commonly called economic (Mises 1966, p. 199).
>
> Monetary calculation is the guiding star of action under the social system of division of labor. It is the compass of the man embarking upon production.
>
> The system of economic calculation in monetary terms is conditioned by certain social institutions. It can operate only in an institutional setting of the division of labor and private ownership of the means of production in which goods and services of all orders are bought and sold against a generally used medium of exchange, i.e., money.
>
> Monetary calculation is the main vehicle of planning and acting in the social setting of a society of free enterprise directed and controlled by the market and its prices.
>
> Our civilization is inseparably linked with our methods of economic calculation. It would perish if we were to abandon this most precious intellectual tool of action (Mises 1966, pp. 229–30).

From this analysis Mises made his criticism of socialism, that it cannot calculate and thus, it is not an *economic* system at all. The attempt to implement socialism must lead to poverty, death, and retrogression of civilization. Mises said, "In abolishing economic calculation the general adoption of socialism would result in complete chaos and the disintegration of social cooperation under the division of labor" (Mises 1966, p. 861). While Mises saw calculation as *the* problem of socialism, Hayek views it as a knowledge problem:

> To the naive mind that can conceive of order only as the product of deliberate arrangement, it may seem absurd that in complex conditions order, and adaptation to the unknown, can be achieved more effectively by decentralizing decisions, and that a division of authority will actually extend the possibility of overall order. Yet that decentralization actually leads to more information being taken into account. This is the main reason for rejecting the requirements of constructivist rationalism (Hayek 1988, pp. 76–77).

Mises demonstrated that even with *perfect* information, the central planners in socialism cannot rationally calculate how to combine resources to render efficient production (Ebeling 1991). They can only grope in the dark; as Mises put it, socialism is "planned chaos," an irrational endeavor that must leach off and mimic capitalism to provide even a subsistence standard of living to its citizens.

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> The paradox of "planning" is that it cannot plan, because of the absence of economic calculation. What is called a planned economy is no economy at all. It is just a system of groping about in the dark. There is no question of a rational choice of means for the best possible attainment of the ultimate ends sought. What is called conscious planning is precisely the elimination of conscious purposive action (Mises 1966, pp. 700–01).

> If no other objections could be raised to the socialist plans than that socialism will lower the standard of living of all or at least of the immense majority, it would be impossible for praxeology to pronounce a final judgment. Men would have to decide the issue between capitalism and socialism on the ground of judgments of value and of judgments of relevance. . . . However, the true state of affairs is entirely different. Man is not in a position to choose between these two systems. Human cooperation under the system of the social division of labor is possible only in the market economy. Socialism is not a realizable system of society's economic organization because it lacks any method of economic calculation (Mises 1966, p. 679).

Mises and the Austrian Tradition

These principles, representing the pinnacle of free-market economic theory, cannot be found in any other modern school of economic thought. By failing to correctly understand the process of the social creation of wealth these other schools have not played a significant, independent role in the current advancement of freedom. Advocates of the free market within other schools have relied upon the basic Austrian arguments or have been relatively ineffective since their economic theories are more easily rebuffed.

What effective defense of the free market has been made by econometrics? By its nature all such work tells us only of what has happened and not what can happen—it cannot result in universal laws applicable to any conceivable historical episode. As such it is easily ignored by those who wish to conduct social experiments for the future. Furthermore, econometrics is coming under increasing criticism as a method capable of rendering useful knowledge at all (see Hoppe 1988).

This criticism extends with equal force to modern neoclassical theory, since it is built upon positivism (Friedman 1974). Milton Friedman tells us that all proper economic theory must be testable and subject to falsification; that economic propositions, like those in physics, are hypothetical, tentative, and forever subject to testing and potential rejection. Yet what basic principles of economics have neoclassical economists rejected for failing tests of statistical significance? The laws of supply and demand? The principle of diminishing marginal utility? The concept of opportunity cost? The idea that exchange leads to

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mutual benefit? Such basic principles are either non-testable, and thus, not positivist economic theories at all, or routinely rejected in econometric tests. Yet all *economic* defenses of the free market are built from basic principles. Friedman and other neoclassical economists say that economic theory must be empirical but they do economic theory deductively, although not as well as Mises.

Neoclassical economics has failed to provide any role in defense of the free market to the extent that it stands outside the Austrian tradition. It contains no free-market principles that are both unique and true. It should be kept in mind that after Mises's devastating article on the inability of socialism to calculate, socialists tried to refute him by using mathematical economics and econometrics to show that, in theory at least, the problem could be solved by a system of equations *if* the economy is perfectly competitive (Ebeling 1991). Their failure has not prevented others from employing the pre-eminent neoclassical theory as an argument *against* the free market. It is a common barb that the free market would be a superior economic system *if* it was perfectly competitive. And since it obviously is not perfectly competitive, then government control is essential.

To the contrary, Mises has shown that the argument for free markets does not depend on *any* type of competition, perfect or otherwise. In contrast, Hayek claims:

> One revealing mark of how poorly the ordering principle of the market is understood is the common notion that "cooperation is better than competition." Cooperation, like solidarity, presupposes a large measure of agreement on ends as well as on methods employed in their pursuit. It makes sense in a small group whose members share particular habits, knowledge and beliefs about possibilities. It makes hardly any sense when the problem is to adapt to unknown circumstances; yet it is this adaptation to the unknown on which the coordination of efforts in the extended order rests. Competition is a procedure of discovery, a procedure involved in all evolution, that led man unwittingly to respond to novel situations; and through further competition, not through agreement, we gradually increase our efficiency.
>
> To operate beneficially, competition requires that those involved observe rules rather than resort to physical force. Rules alone can unite an extended order. Neither all ends pursued, nor all means used, are known or need to be known to anybody, in order for them to be taken account of within a spontaneous order. Such an order forms of itself (Hayek 1988, pp. 19–20).
>
> Biological and cultural evolution share other features too. For example, they both rely on the same principle of selection: survival or reproductive advantage. Variation, adaptation and competition are essentially the same kind of process, however different their particular

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> mechanisms, particularly those pertaining to propagation. Not only does all evolution rest on competition; continuing competition is necessary even to preserve existing achievements (Hayek 1988, p. 26).

Mises has shown that the social division of labor is not an arena of competition but cooperation, a complex network of voluntary interaction that is absolutely necessary for the continuing life and prosperity of the world's population. If people fail to understand this and act against their "rightly understood interests" then prosperity and civilization will end.

> What makes friendly relations between human beings possible is the higher productivity of the division of labor. It removes the natural conflict of interests. For where there is division of labor, there is no longer question of the distribution of a supply not capable of enlargement. Thanks to the higher productivity of labor performed under the division of tasks, the supply of goods multiplies. A pre-eminent common interest, the preservation and further intensification of social cooperation, becomes paramount and obliterates all essential collisions. Catallactic competition is substituted for biological competition. It makes for harmony of the interests of all members of society. The very condition from which the irreconcilable conflicts of biological competition arise—viz., the fact that all people by and large strive after the same things—is transformed into a factor making for harmony of interests. Because many people or even all people want bread, clothes, shoes, and cars, large-scale production of these goods becomes feasible and reduces the costs of production to such an extent that they are accessible at low prices. The fact that my fellow man wants to acquire shoes as I do, does not make it harder for me to get shoes, but easier. What enhances the price of shoes is the fact that nature does not provide a more ample supply of leather and other raw material required, and that one must submit to the disutility of labor in order to transform these raw materials into shoes. The catallactic competition of those who, like me, are eager to have shoes makes shoes cheaper, not more expensive.
>
> This is the meaning of the theorem of the harmony of the rightly understood interests of all members of the market society (Mises 1966, pp. 673–74).

Most "free-market" economists have failed to absorb Mises's analysis of capitalism and socialism and thus hold to some form of a mixed economy. As Mises has shown this view is untenable.

> The market economy must be strictly differentiated from the second thinkable—although not realizable—system of social cooperation under the division of labor: the system of social or governmental ownership of the means of production. This second system is commonly called socialism, communism, planned economy, or state capitalism. The market economy or capitalism, as it is usually called,

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> and the socialist economy preclude one another. There is no mixture of the two systems possible or thinkable; there is no such thing as a mixed economy, a system that would be in part capitalistic and in part socialist. Production is directed by the market or by the decrees of a production tsar or a committee of production tsars.
>
> If within a society based on private ownership by the means of production some of these means are publicly owned and operated—that is, owned and operated by the government or one of its agencies—this does not make for a mixed system which would combine socialism and capitalism. . . . These publicly owned and operated enterprises are subject to the sovereignty of the market. They must fit themselves, as buyers of raw materials, equipment, and labor, and as sellers of goods and services, into the scheme of the market economy. They are subject to the laws of the market and thereby depend on the consumers who may or may not patronize them. They must strive for profits or, at least, to avoid losses. The government may cover losses of its plants or shops by drawing on public funds. But this neither eliminates nor mitigates the supremacy of the market; it merely shifts it to another sector.
>
> Nothing that is in any way connected with the operation of a market is in the praxeological or economic sense to be called socialism. The notion of socialism as conceived and defined by all socialists implies the absence of a market for factors of production and of prices of such factors. The "socialization" of individual plants, shops, and farms—that is, their transfer from private into public ownership—is a method of bringing about socialism by successive measures. It is a step on the way toward socialism, but not in itself socialism (Mises 1966, pp. 258–59).

This step-by-step process, in reverse, is the council given to the countries of Eastern and Central Europe by today's self-proclaimed, free-market economists. After moving toward capitalism, they are to stop at some optimum amount of government intervention. But Mises showed long ago that interventionism is an unstable middle ground between capitalism and socialism that must continue in motion toward one or the other.

> The system of interventionism or of the hampered market economy differs from the German pattern of socialism by the very fact that it is still a market economy. The authority interferes with the operation of the market economy, but does not want to eliminate the market altogether. It wants production and consumption to develop along lines different from those prescribed by an unhampered market, and it wants to achieve its aim by injecting into the working of the market orders, commands, and prohibitions for whose enforcement the police power and its apparatus of violent compulsion and coercion stand ready. But these are *isolated* acts of an integrated system which determines all

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> prices, wages and interest rates and thus places full control of production and consumption into the hands of the authorities.
>
> The system of the hampered market economy or interventionism aims at preserving the dualism of the distinct spheres of government activities on the one hand and economic freedom under the market system on the other hand. What characterizes it as such is the fact that the government does not limit its activities to the preservation of private ownership of the means of production and its protection against violent or fraudulent encroachments. The government interferes with the operation of business by means of orders and prohibitions (Mises 1966, p. 718).
>
> The interventionist doctrinaires repeat again and again that they do not plan the abolition of private ownership of the means of production, of entrepreneurial activities, and or market exchange. . . . It is necessary, they say, that the state interfere with the market phenomena whenever and wherever the "free play of the economic forces" results in conditions that appear as "socially" undesirable. In making this assertion they take it for granted that it is the government that is called upon to determine in every single case whether or not a definite economic fact is to be considered as reprehensible for the "social" point of view and, consequently whether or not the state of the market requires a special act of government interference.
>
> All these champions of interventionism fail to realize that their program thus implies the establishment of full government supremacy in all economic matters and ultimately brings about a state of affairs that does not differ from what is called the German or the Hindenburg pattern of socialism. If it is in the jurisdiction of the government to decide whether or not definite conditions of the economy justify its intervention, no sphere of operation is left to the market. Then it is no longer the consumers who ultimately determine what should be produced, in what quantity, of what quality, by whom, where, and how—but it is the government. For as soon as the outcome brought about by the operation of the unhampered market differs from what the authorities consider "socially" desirable, the government interferes. That means the market is free as long as it does precisely what the government wants it to do. . . . Thus the doctrine and the practice of interventionism ultimately tend to abandon what originally distinguished them from outright socialism and to adopt entirely the principles of totalitarian all-round planning (Mises 1966, pp. 723–24).

In Mises's view what we are witnessing today is not the collapse of socialism, since socialism cannot be realized in full, but the collapse of a form of interventionism. He predicted this in 1949: "The interventionist interlude must come to an end because interventionism cannot lead to a permanent system of social organization" (Mises 1966, p. 858). This must happen because interventionism restricts

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the goods available to consumers; and fails to bring about the end aimed at, leading to a situation worse than the pre-intervention once it has exhausted the "surplus" it seeks to confiscate (Mises 1966, p. 858). The outcome of changes in Europe depend upon understanding and accepting these Misesian ideas.

> Optimists hope that at least those nations which have in the past developed the capitalist market economy and its civilization will cling to this system in the future too. There are certainly as many signs to confirm as to disprove such an expectation. It is vain to speculate about the outcome of the great ideological conflict between the principles of private ownership and public ownership, of individualism and totalitarianism, of freedom and authoritarian regimentation. All that we can know beforehand about the result of this struggle can be condensed in the following three statements:
>
> (1) We have no knowledge whatever about the existence and operation of agencies which would bestow final victory in this clash on those ideologies whose application will secure the preservation and further intensification of societal bonds and the improvement of mankind's material well-being. Nothing suggests the belief that progress toward more satisfactory conditions is inevitable or a relapse into very unsatisfactory conditions impossible.
>
> (2) Men must choose between the market economy and socialism. They cannot evade deciding between these alternatives by adopting a "middle-of-the-road" position, whatever name they may give to it.
>
> (3) In abolishing economic calculation the general adoption of socialism would result in complete chaos and the disintegration of social cooperation under the division of labor (Mises 1966, p. 861).

We are all participating in this great ideological struggle and thus economic education holds paramount importance.

> Economics must not be relegated to classrooms and statistical offices and must not be left to exoteric circles. It is the philosophy of human life and action and concerns everybody and everything. It is the pith of civilization and of man's human existence.
>
> There is no means by which anyone can evade his personal responsibility. Whoever neglects to examine to the best of his abilities all the problems involved voluntary surrenders his birthright to a self-appointed elite of supermen. In such vital matters blind reliance upon "experts" and uncritical acceptance of popular catchwords and prejudices is tantamount to the abandonment of self-determination and to yielding to other people's domination. As conditions are today, nothing can be more important to every intelligent man than economics. His own fate and that of his progeny is at stake (Mises 1966, p. 878).

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Conclusions

The Austrian tradition is identified by and built upon praxeology—the application of deductive reasoning to the irrefutable fact of human action. This method is the red thread that runs from Menger to Böhm-Bawerk to Mises to Murray Rothbard and the modern practitioners of Austrian economics. Working within this tradition, economists have produced a great edifice of irrefutable, universally applicable economic theory. They have shown how the free market advances mankind in its struggle against scarcity and why socialism cannot do so. They have taught us that we must choose one of these two social arrangements, since no system exists between them. We must make our selection and advance, by education and persuasion, either capitalism or socialism. Let us choose wisely.

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The End of Socialism and the Calculation Debate Revisited

Murray N. Rothbard*

At the root of the dazzling revolutionary implosion and collapse of socialism and central planning in the "socialist bloc" is what everyone concedes to be a disastrous economic failure. The peoples and the intellectuals of Eastern Europe and the Soviet Union are crying out not only for free speech, democratic assembly, and *glasnost*, but also for private property and free markets. And yet, if I may be pardoned a moment of nostalgia, four-and a-half-decades ago, when I entered graduate school, the economics Establishment of that era was closing the book on what had been for two decades the famed "socialist calculation debate." And they had all decided, left, right, and center, that there was not a thing economically wrong with socialism: that socialism's only problems, such as they might be, were *political*. Economically, socialism could work just as well as capitalism.

Mises and the Challenge of Calculation

Before Ludwig von Mises raised the calculation problem in his celebrated article in 1920,[1] everyone, socialists and non-socialists alike, had long realized that socialism suffered from an *incentive problem*. If, for example, everyone under socialism were to receive an equal income, or, in another variant, everyone was supposed to produce "according to his ability" but receive "according to his needs," then, to sum it up in the famous question: Who, under socialism, will take out the garbage? That

*Murray N. Rothbard is the S. J. Hall distinguished professor of economics at the University of Nevada, Las Vegas and editor of the *Review of Austrian Economics*.

[1]Mises's article, published in 1920 in German, "Die Wirtschaftsrechnung im sozialistischen Gemeinwesen," was only made available in English in 1935: Mises, "Economic Calculation in the Socialist Commonwealth," in F. A. Hayek, ed., *Collectivist Economic Planning* (London: Routledge and Sons, 1935), pp. 87–130. The article was republished as a monograph by the Mises Institute with a notable postscript by Professor Joseph T. Salerno (Ludwig von Mises, *Economic Calculation in the Socialist Commonwealth* [Auburn, Ala.: Ludwig von Mises Institute, 1990]).

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is, what will be the incentive to do the grubby jobs, and, furthermore, to do them well? Or, to put it another way, what would be the incentive to work hard and be productive *at any job*?

The traditional socialist answer held that the socialist society would transform human nature, would purge it of selfishness, and remold it to create a New Socialist Man. That new man would be devoid of any selfish, or indeed any self-determined, goals; his only wish would be to work as hard and as eagerly as possible to achieve the goals and obey the orders of the socialist State. Throughout the history of socialism, socialist *ultras*, such as the early Lenin and Bukharin under "War Communism," and later Mao Tse-tung and Che Guevara, have sought to replace material by so-called "moral" incentives. This notion was properly and wittily ridiculed by Alexander Gray as "the idea that the world may find its driving force in a Birthday Honours List (giving to the King, if necessary, 165 birthdays a year)."[2] At any rate, the socialists soon found that voluntary methods could hardly yield them the New Socialist Man. But even the most determined and bloodthirsty methods could not avail to create this robotic New Socialist Man. And it is a testament to the spirit of freedom that cannot be extinguished in the human breast that the socialists continued to fail dismally, despite decades of systemic terror.

But the uniqueness and the crucial importance of Mises's challenge to socialism is that it was totally unrelated to the well-known incentive problem. Mises in effect said: All right, suppose that the socialists have been able to create a mighty army of citizens all eager to do the bidding of their masters, the socialist planners. What exactly would those planners tell this army to do? How would they know what products to order their eager slaves to produce, at what stage of production, how much of the product at each stage, what techniques or raw materials to use in that production and how much of each, and where specifically to locate all this production? How would they know their costs, or what process of production is or is not efficient?

Mises demonstrated that, in any economy more complex than the Crusoe or primitive family level, the socialist planning board would simply not know what to do, or how to answer any of these vital questions. Developing the momentous concept of *calculation*, Mises pointed out that the planning board could not answer these questions because socialism would lack the indispensable tool that private entrepreneurs use to appraise and calculate: the existence of a market in the means of production, a market that brings about money

[2]Alexander Gray, *The Socialist Tradition* (London: Longmans, Green, 1946), p. 90.

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prices based on genuine profit-seeking exchanges by private owners of these means of production. Since the very essence of socialism is collective ownership of the means of production, the planning board would not be able to plan, or to make any sort of rational economic decisions. Its decisions would necessarily be completely arbitrary and chaotic, and therefore the existence of a socialist planned economy is literally "impossible" (to use a term long ridiculed by Mises's critics).

The Lange-Lerner "Solution"

In the course of intense discussion throughout the 1920s and 1930s, the socialist economists were honest enough to take Mises's criticism seriously, and to throw in the towel on most traditional socialist programs: in particular, the original communist vision that workers, not needing such institutions as bourgeois money fetishism, would simply produce and place their products on some vast socialist heap, with everyone simply taking from that heap "according to his needs." The socialist economists also abandoned the Marxian variant that everyone should be paid according to the labor time embodied into his product. In contrast, what came to be known as the Lange-Lerner solution (or, less commonly but more accurately, the Lange-Lerner-Taylor solution), acclaimed by virtually all economists, asserted that the socialist planning board could easily resolve the calculation problem by ordering its various managers to fix accounting prices. Then, according to the contribution of Professor Fred M. Taylor, the central planning board could find the proper prices in much the same way as the capitalist market: trial and error. Thus, given a stock of consumer goods, if the accounting prices are set too low, there will be a shortage, and the planners will raise prices until the shortage disappears and the market is cleared. If, on the other hand, prices are set too high, there will be a surplus on the shelves, and the planners will lower the price, until the markets are cleared. The solution is simplicity itself![3]

In the course of his two-part article and subsequent book, Lange concocted what could only be called the Mythology of the Socialist Calculation Debate, a mythology which, aided and abetted by Joseph Schumpeter, was accepted by virtually all economists of whatever ideological stripe. It was this mythology which I found handed down as

[3]Oskar Lange's well-known article was originally in two parts: "On the Economic Theory of Socialism," *Review of Economic Studies* 4 (October 1936): 53–71, and ibid. 5 (February 1937): 132–42; Fred M. Taylor's article was "The Guidance of Production in a Socialist State," *American Economic Review* 19 (March 1929); Taylor was reprinted and Lange revised and published in Oskar Lange and Fred M. Taylor, *On the Economic Theory of Socialism*, B. Lippincott, ed. (Minneapolis: University of Minnesota Press, 1938).

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the Orthodox Line when I entered Columbia University's graduate school at the end of World War II—a line promulgated in lectures by no less an expert on the Soviet economy than Professor Abram Bergson, then at Columbia. In 1948, indeed, Professor Bergson was selected to hand down the Received Opinion on the subject by a committee of the American Economic Association, and Bergson interred the socialist calculation question with the Orthodox Line as its burial rite.[4]

The Lange-Bergson Orthodox Line went about as follows: Mises, in 1920, had done an inestimable service to socialism by raising the problem of economic calculation, a problem of which socialists had not generally been aware. Then Pareto and his Italian disciple Enrico Barone had shown that Mises's charge, that socialist calculation was impossible, was incorrect, since the requisite number of supply, demand, and price equations existed under socialism as under a capitalist system. At that point, F. A. Hayek and Lionel Robbins, abandoning Mises's extreme position, fell back on a second line of defense: that, while the calculation problem could be solved *theoretically*, in practice it would be too difficult. Thereby Hayek and Robbins fell back on a practical problem, or one of degree of efficiency rather than of a drastic difference in kind. But now, happily, the day has been saved for socialism, since Taylor-Lange-Lerner have shown that, by jettisoning utopian ideas of a money-less or price-less socialism, or of pricing according to a labor theory of value, the socialist Planning Board can solve these pesky equations simply by the good old capitalist method of trial and error.[5]

Bergson, attempting to be magisterial in his view of the debate, summed up Mises as contending that "without private ownership of, or (what comes to the same thing for Mises) a free market for the means of production, the rational evaluation of these goods for the purposes of calculating costs is ruled out . . ." Bergson correctly adds that to put Mises's point

> somewhat more sharply than is customary, let us imagine a Board of Supermen, with unlimited logical faculties, with a complete scale of values for the different consumers goods', and present and future consumption, and detailed knowledge of production techniques. Even such a Board would be unable to evaluate rationally the means of production. In the absence of a free market for these goods, decisions

[4]Abram Bergson, "Socialist Economics," in H. S. Ellis, ed., *A Survey of Contemporary Economics* (Philadelphia: Blakiston, 1948), pp. 412–48.

[5]Lange was aided in this construction by being able to use Hayek's collection of articles on the subject, which had just been published the year before his first article, as a useful foil. Hayek's volume included the seminal article by Mises, other contributions by Pierson and Halm, two articles by Hayek himself, and the alleged refutation of Mises by Barone. See Hayek, *Collectivist Economic Planning*.

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> on resource allocation in Mises' view necessarily would be on a haphazard basis.

Bergson sharply comments that this "argument is easily disposed of." Lange and Schumpeter both point out that, as Pareto and Barone had shown,

> once tastes and techniques are given, the values of the means of production can be determined unambiguously by imputation without the intervention of a market process. The Board of Supermen could decide readily how to allocate resources so as to assure the optimum welfare. It would simply have to solve the equations of Pareto and Barone.[6]

So much for Mises. As for the Hayek-Robbins problem of practicality, Bergson adds, that can be settled by the Lange-Taylor trial-and-error method; any remaining problems are only a matter of degree of efficiency, and political choices. The Mises problem has been satisfactorily solved.

Some Fallacies of the Lange-Lerner Solution

The breathtaking naivete of the Orthodox Line should have been evident even in the 1940s. As Hayek later chided Schumpeter on the assumption of "imputation" outside the market, this formulation "presumably means . . . that the valuation of the factors of production is implied in, or follows necessarily from, the valuation of consumers' goods. But . . . implication is a logical relationship which can be meaningfully asserted only of propositions simultaneously present to one and the same mind."[7]

Economists were convinced of the Lange solution because they had already come under the sway of the Walrasian general equilibrium model; Schumpeter, for example, was an ardent Walrasian. In this model, the economy is always in static general equilibrium, a changeless world in which all "data"—tastes or value scales, alternative technologies, and lists of resources—are known to everyone, and where costs are known and always equal to price. The Walrasian world is also one of "perfect" competition, where prices are given to all managers. Indeed, both Taylor and Lange make the point that the Socialist Planning Board will be better able to calculate than capitalist markets, since the socialist planners can ensure "perfect competition," whereas the real world of capitalism is shot through with various sorts of "monopolies"! The socialist planners can act like the

[6]Bergson, "Socialist Economics," p. 446.

[7]F. A. Hayek, "The Use of Knowledge in Society" (1945), in Hayek, *Individualism and Economic Order* (Chicago: University of Chicago Press, 1948), p. 90.

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absurdly fictional Walrasian "auctioneer," bringing about equilibrium rapidly by trial and error.

Set aside the obvious absurdity of trusting a coercive governmental monopoly to act somehow as if it were in "perfect competition" with parts of itself. Another grievous flaw in the Lange model is thinking that general equilibrium, a world of certainty where there is no room for the driving force of entrepreneurship, can somehow be used to depict the real world. The actual world is one not of changeless "givens" but of incessant change and systemic uncertainty. Because of this uncertainty, the capitalist entrepreneur, who stakes assets and resources in attempting to achieve profits and avoid losses, becomes the crucial actor in the economic system, an actor who can in no way be portrayed by a world of general equilibrium. Furthermore, it is ludicrous, as Hayek pointed out, to think of general equilibrium as the only legitimate "theory," with all other areas or problems dismissed as mere matters of practicality and degree. No economic theory worth its salt can be worthwhile if it omits the role of the entrepreneur in an uncertain world. The Pareto-Barone-Lange, etc. "equations" is not simply excellent theory that faces problems in practice; for in order to be "good," a theory must be useful in explaining real life.[8]

Another grave flaw in the Lange-Taylor trial-and-error approach is that it concentrates on consumer good pricing. It is true that retailers, given the stock of a certain type of good, can clear the market by adjusting the prices of that good upward or downward. But, as Mises pointed out in his original 1920 article, consumers goods are not the real problem. Consumers, these "market socialists" are postulating, are free to express their values by using money they had earned on a range of consumers' goods. Even the labor market—at least in principle[9]—can be treated as a market with self-owning suppliers who are free to accept or reject bids for their labor and to move to different occupations. The real problem, as Mises has insisted from the beginning, is in all the intermediate markets for land and capital goods. Producers have to use land and capital resources to

[8]The silliness of hailing Barone's essay as a refutation of Mises is highlighted by the fact that Barone's article was published in 1908, twelve years before Mises's article which it is supposed to have refuted. The date was well known to, and made no impression upon, Ludwig von Mises. Moreover, Barone and Pareto themselves had only scorn for any notion that their equations could aid socialist planning. See Trygve J. B. Hoff, *Economic Calculation in the Socialist Society* (1949; Indianapolis, Ind.: Liberty Press, 1981), pp. 222–23.

[9]Here, as in other parts of his argument—as we shall see further below—Mises is leaning over backward to concede the market socialists their best case, and is not considering whether such free consumer or labor markets are really likely in a world where the state is the only seller, as well as the only purchaser, of labor.

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decide what the stocks of the various consumer goods should be. Here there are a huge number of markets where the State monopoly can only be both buyer and seller for each transaction, and these intra-monopoly, intra-state transactions permeate the most vital markets of an advanced economy—the complex lattice-work of the capital markets. And here is precisely where calculational chaos necessarily reigns, and there is no way for rationality to intrude on the immense number of decisions on the allocation of prices and factors of production in the structure of capital goods.

Mises's Rebuttal: The Entrepreneur

Moreover, Mises's brilliant and devastating rebuttal to his Lange-Lerner "market socialism" critics has virtually never been considered—neither by the economics establishment nor by the post-World War II Hayekians. In both cases, the writers were eager to dispose of Mises as having safely made his pioneering contribution in 1920, but being superseded later, either by Lange-Lerner or by Hayek, as the case may be. In both cases, it was inconvenient to ponder that Mises continued to elaborate his position with a penetrating critique of his critics, or that Mises's "extreme" formulation may, after all, have been correct.[10]

Mises began his rebuttal in *Human Action* by discussing the "trial-and-error" method, and pointing out that this process only works in the capitalist market. There the entrepreneurs are strongly motivated to make greater profits and to avoid losses, and further, such a criterion does not apply to the capital goods or land market under socialism where all resources are controlled by one entity, the government.

Continuing his reply, Mises pressed on to a brilliant critique, not only of socialism, but of the entire Walrasian general equilibrium model. The major fallacy of the "market socialists," Mises pointed out, is that they look at the economic problem from the point of view of

[10]Mises's later rebuttal is in his *Human Action* (New Haven: Yale University Press, 1949), pp. 694–711. For the establishment, the debate was supposed to be over by 1938. For an example of a Hayekian survey of the debate that does not bother to so much as mention *Human Action*, see Karen I. Vaughn, "Introduction," in Hoff, *Economic Calculation*, pp. ix–xxxvii. Indeed, in an earlier paper, Vaughn had sneered that "Mises' so-called final refutation in *Human Action* is mostly polemic and glosses over the real problems . . ." Vaughn, "Critical Discussion of the Four Papers," in Lawrence Moss, ed. *The Economics of Ludwig von Mises* (Kansas City: Sheed and Ward, 1976), p. 107. The Hayekian doctrine will be treated further below.

For a refreshing example of an outstanding Misesian contribution to the debate that does not neglect or deprecate *Human Action* but rather builds upon it, see Joseph T. Salerno, "Ludwig von Mises as Social Rationalist," *Review of Austrian Economics* 4 (1990): 36–48. Also see Salerno, "Why Socialist Economy is *Impossible*," a Postscript to Mises, *Economic Calculation in the Socialist Commonwealth* (Auburn, Ala.: Ludwig von Mises Institute, 1990).

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the manager of the individual firm, who seeks to make profits or avoid losses within a rigid framework of a given, external allocation of capital to each of the various branches of industry and indeed to the firm itself. In other words, the "market socialist" manager is akin, not to the real driving force of the capitalist market, the capitalist entrepreneur, but rather to the relatively economically insignificant manager of the corporate firm under capitalism. As Mises brilliantly puts it:

> the cardinal fallacy implied in [market socialist] proposals is that they look at the economic problem from the perspective of the subaltern clerk whose intellectual horizon does not extend beyond subordinate tasks. They consider the structure of industrial production and the allocation of capital to the various branches and production aggregates as rigid, and do not take into account the necessity of altering this structure in order to adjust it to changes in conditions. . . . They fail to realize that the operations of the corporate officers consist merely in the loyal execution of the tasks entrusted to them by their bosses, the shareholders. . . . The operations of the managers, their buying and selling, are only a small segment of the totality of market operations. The market of the capitalist society also performs those operations which allocate the capital goods to the various branches of industry. The entrepreneurs and capitalists establish corporations and other firms, enlarge or reduce their size, dissolve them or merge them with other enterprises; they buy and sell the shares and bonds of already existing and of new corporations; they grant, withdraw, and recover credits; in short they perform all those acts the totality of which is called the capital and money market. It is these financial transactions of promoters and speculators that direct production into those channels in which it satisfies the most urgent wants of the consumers in the best possible way.[11]

Mises goes on to remind the reader that the corporate manager performs only a "managerial function," a subsidiary service that "can never become a substitute for the entrepreneurial function." Who are the capitalist-entrepreneurs? They are "the speculators, promoters, investors and moneylenders, [who] in determining the structure of the stock and commodity exchanges and of the money market, circumscribe the orbit within which definite tasks can be entrusted to the manager's discretion." The crucial question, Mises continues, is not managerial activities, but: "In which branches should production be increased or restricted, in which branches should the objective of production be altered, what new branches should be inaugurated?" In short, the crucial decisions in the capitalist economy are the allocation of capital to firms and industries. "With regard to these issues," Mises

[11]Mises, *Human Action*, pp. 703–04.

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adds, "it is vain to cite the honest corporation manager and his well-tried efficiency. Those who confuse entrepreneurship and management close their eyes to the economic problem . . . The capitalist system is not a managerial system; it is an entrepreneurial system."

But here, Mises triumphantly concludes, no "market socialist" has ever suggested preserving or carrying over, much less understood the importance of, the specifically entrepreneurial functions of capitalism:

> Nobody has ever suggested that the socialist commonwealth could invite the promoters and speculators to continue their speculations and then deliver their profits to the common chest. Those suggesting a quasi-market for the socialist system have never wanted to preserve the stock and commodity exchanges, the trading in futures, and the bankers and money-lenders as quasi-institutions.[12]

Mises has been cited as stating, in *Human Action,* that it is absurd for the socialist planning board to tell their managers to "play market," to act *as if* they are owners of their firms in trying to maximize profits and avoid losses. But it is important to stress that Mises was focusing, not so much on the individual managers of socialist "firms," but on the speculators and investors who decide the crucial allocations of capital throughout the structure of industry. It is at least conceivable that one can order a manager to play market and act as if he were enjoying the profits and suffering losses; but it is clearly ludicrous to ask investors and capital speculators to act as if their fortunes were at stake. As Mises adds:

> one cannot *play* speculation and investment. The speculators and investors expose their own wealth, their own destiny. This fact makes them responsible to the consumers, the ultimate bosses of the capitalist economy. If one relieves them of this responsibility, one deprives them of their very character.[13]

One time, during Mises's seminar at New York University, I asked him whether, considering the broad spectrum of economies from a purely free market economy to pure totalitarianism, he could single out one criterion according to which he could say that an economy was essentially "socialist" or whether it was a market economy. Somewhat to my surprise, he replied readily: "Yes, the key is whether the economy has a stock market." That is, if the economy has a full-scale market in titles to land and capital goods. In short: Is the allocation of capital basically determined by government or by private owners? At the time, I did not fully understand the vital importance

[12]Ibid., pp. 704–05.
[13]Ibid., p. 705.

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of Mises's answer, which I realized recently when poring over the great merits of the Misesian, as compared to the Hayekian, analysis of the socialist calculation problem.

For Mises, in short, the key to the capitalist market economy and its successful functioning is the entrepreneurial forecasting and decisionmaking of private owners and investors. The key is emphatically *not* the more minor decisions made by corporate managers within a framework already set by entrepreneurs and the capital markets. And it is obvious that Lange, Lerner, and the other market socialists merely envisioned the relatively lesser managerial decisions. These economists, who had never grasped the function of speculation or capital markets, therefore had no idea that they would need to be or could be replicated in a socialist system.[14] And this is not surprising, since in the Walrasian general micro-equilibrium model, there is no capital structure, there is no role for capital, and capital theory has become totally submerged into "growth theory," that is, growth of a homogeneous "level," or blob, of aggregate macro-capital. The allocation of capital is considered external and given, and receives no consideration.

The Structure of Capital

Joseph Schumpeter and Frank H. Knight are interesting examples of two eminent economists who were personally anti-socialist but were seduced by their Walrasian devotion to general equilibrium and their lack of a genuine capital theory into strongly endorsing the orthodox view that there is no economic calculation problem under socialism. In particular, in capital theory, both Schumpeter and Knight were disciples of J. B. Clark, who denied any role at all for time in the process of production. For Schumpeter, production takes no time because production and consumption are somehow always "synchronized." Time is erased from the picture, even to assuming away the existence of any accumulated stocks of capital goods, and therefore of any age structure of such goods. Since production is magically synchronized, there is then no necessity for land or labor to receive advances in payment from capitalists out of accumulated savings. Schumpeter achieves this feat by sundering capital completely from its embodiment in capital goods, and limiting the concept to a money fund used to purchase such goods.[15]

Frank Knight, the doyen of the Chicago School, was also an ardent

[14]The fact that some socialist bloc countries, such as Hungary, now permit a stock market, albeit small and truncated, and that other ex-communist countries are seriously considering introducing such capital markets, demonstrates the enormous importance of the de-socialization now under way in Eastern Europe.

[15]See Murray N. Rothbard, "Breaking Out of the Walrasian Box: The Cases of Schumpeter and Hansen," *Review of Austrian Economics* 1 (1987): 98–100, 107.

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believer in the Clarkian view that time preference has no influence on interest paid by producers, and that production is synchronized so that time plays no role in the production structure. Hence, Knight believed, along with modern orthodoxy, that capital is a homogeneous, self-perpetuating blob that *has no* lattice-like, time-oriented structure. Knight's fiercely anti-Böhm-Bawerkian, anti-Austrian views on capital and interest led him to a then-famous war of journal articles over capital theory during the 1930s, a war he won by default when Austrianism disappeared because of the Keynesian Revolution.[16]

In his negative review of Mises's *Socialism*, Frank Knight, after hailing Lange's "excellent" 1936 article, brusquely dismisses the socialist calculation debate as "largely sound and fury." To Knight, it is simply "truistical" that the "technical basis of economic life" would continue as before under socialism, and that therefore "the managers of various technical units in production—farms, factories, railways, stores, etc.—would carry on in essentially the same way." Note, there is no reference whatever to the crucial capital market, or to the allocation of capital to various branches of production. If capital is an automatically renewing homogeneous blob, all one need worry about is growth in the amount of that blob. Hence, Knight concludes that "socialism is a political problem, to be discussed in terms of social and political psychology, and economic theory has relatively little to say about it."[17] Certainly, that is true of Knight's orthodox-Chicagoite brand of economic theory!

It is instructive to compare the naivete and the brusque dismissal

[16]On Knight vs. Hayek, Machlup, and Boulding in the 1930s, see F. A. Hayek, "The Mythology of Capital," in W. Fellner and B. Haley, eds., *Readings in the Theory of Income Distribution* (Philadelphia: Blakiston, 1946), pp. 355–83. For a Knightian attack on the Austrian discounted marginal productivity theory on behalf of what is now the orthodox undiscounted (by time-preference) marginal productivity theory, see Earl Rolph, "The Discounted Marginal Productivity Doctrine," ibid., pp. 278–93. For an Austrian rebuttal, see Murray N. Rothbard, *Man, Economy, and State*, vol. 1 (Los Angeles: Nash, 1970), pp. 431–33; and Walter Block, "The DMVP-MVP Controversy: A Note," *Review of Austrian Economics* 4 (1990): 199–207.

[17]Frank H. Knight, "Review of Ludwig von Mises, *Socialism*," *Journal of Political Economy* 46 (April 1938): 267–68. In another review in the same issue of the journal, Knight claims that there *would* be a "capital market" under socialism, but it is clear that he is referring only to a market for loans, and not to a genuine market in equities throughout the production structure. Here again, Mises has a devastating critique of this sort of scheme in *Human Action*, pointing out that managers bidding for governmental planning board funds would not be bidding for or staking their own property, and hence they would "not be restrained by any financial dangers they themselves run in promising too high a rate of interest for the funds borrowed. . . . All the hazards of this insecurity fall only upon society, the exclusive owner of all resources available. If the director were without hesitation to allocate the funds available to those who bid most, he would simply . . . abdicate in favor of the least scrupulous visionaries and scoundrels." See Knight, "Two Economists on Socialism," *Journal of Political Economy* 46 (April 1938): 248; and Mises, *Human Action*, p. 705.

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of the problem by Schumpeter and Knight with the penetrating Misesian critique of socialism by Professor Georg Halm:

> Because capital is no longer owned by many private persons, but by the community, which itself disposes of it directly, a rate of interest *can* no longer be determined. A pricing process is always possible only when demand and supply meet in a market. . . . In the socialist economy . . . there can be no demand and no supply when the capital from the outset is in the possession of its intending user, in this case the socialistic central authority.
>
> Now it might perhaps be suggested that, since the rate of interest cannot be determined automatically, it should be fixed by the central authority. But this likewise would be quite impossible. It is true that the central authority would know quite well how many capital goods of a given kind it possessed or could procure . . .; it would know the capacity of the existing plant in the various branches of production; *but it would not know how scarce capital was*. For the scarcity of means of production must always be related to the demand for them, whose fluctuations give rise to variations in the value of the good in question . . .
>
> If it should be objected that a price for consumption-goods would be established, and that in consequence the intensity of the demand and so the value of the means of production would be determinate, this would be a further serious mistake. . . . The demand for means of production, labor and capital goods, is only indirect.

Halm goes on to add that if there were only one single factor of production in making consumers' goods, the socialist "market" might be able to determine its proper price. But this can not be true in the real world where *several* factors of production take part in the production of goods in various markets.

Halm then adds that the central authority, contrary to his above concession, would not *even* be able to find out how much capital it is employing. For capital goods are heterogeneous, and therefore how "can the total plant of one factory be compared with that of another? How can a comparison be made between the values of even only two capital-goods?" In short, while under capitalism such comparisons can be made by means of money prices set on the market for every good, in the socialist economy the absence of genuine money prices arising out of a market precludes any such value comparisons. Hence, there is also no way for a socialist system to rationally estimate the costs (which are dependent on prices in factor markets) of any process of production.[18]

[18]Georg Halm, "Further Considerations on the Possibility of Adequate Calculation in a Socialist Community," in Hayek, *Collectivist Economic Planning*, pp. 162–65. Also see ibid., pp. 13–200.

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Mises's Rebuttal: Valuation and Monetary Appraisement

In his original 1920 article, Mises emphasized that "as soon as one gives up the conception of a freely established monetary price for goods of a higher order, rational production becomes completely impossible." Mises then states, prophetically:

> One may anticipate the nature of the future socialist society. There will be hundreds and thousands of factories in operation. Very few of these will be producing wares ready for use; in the majority of cases what will be manufactured will be unfinished goods and production goods. All these concerns will be interrelated. Every good will go through a whole series of stages before it is ready for use. In the ceaseless toil and moil of this process, however, the administration will be without any means of testing their bearings. It will never be able to determine whether a given good has not been kept for a superfluous length of time in the necessary processes of production, or whether work and material have not been wasted in its completion. How will it be able to decide whether this or that method of production is the more profitable? At best it will only be able to compare the quality and quantity of the consumable end-product produced, but will in the rarest cases be in a position to compare the expenses entailed in production.

Mises points out that while the government may be able to know what ends it is trying to achieve, and what goods are most urgently needed, it will have no way of knowing the other crucial element required for rational economic calculation: valuation of the various means of production, which the capitalist market can achieve by the determination of money prices for all products and their factors.[19]

Mises concludes that, in the socialist economy "in place of the economy of the 'anarchic' method of production, recourse will be had to the senseless output of an absurd apparatus. The wheels will turn, but will run to no effect."[20]

Moreover, in his later rebuttal to the champions of the Pareto-Barone equations, Mises points out that the crucial problem is not simply that the economy is not and can never be in the general equilibrium state described by these differential equations. In addition to other grave problems with the equilibrium model (e.g.: that the socialist planners do not now know their value scales in future

[19]Mises, "Economic Calculation in the Socialist Commonwealth," pp. 106–08.

[20]Ibid., p. 106. This conclusion of 1920 is strikingly close to the quip common in the Poland of 1989, as reported by Professor Krzyztof Ostazewski of the University of Louisville: that the socialist planned economy is "a value-shredding machine run by an imbecile."

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equilibrium; that money and monetary exchange cannot fit into the model; that units of productive factors are neither perfectly divisible nor infinitesimal—and that marginal utilities of different people cannot be equated—on the market or anywhere else), the equations "do not provide any information about the human actions by means of which the hypothetical state of equilibrium" has been or can be reached. In short, the equations offer no information whatever on how to get from the existing disequilibrium state to the general equilibrium goal.

In particular, Mises points out, "even if, for the sake of argument, we assume that a miraculous inspiration has enabled the director without economic calculation to solve all problems concerning the most advantageous arrangement of all production activities and that the price image of the final goal he must aim at is present to his mind," there remain crucial problems on the path from here to there. For the socialist planner does not start from scratch and then build a capital goods structure most perfectly designed to meet his goals. He necessarily starts with a capital goods structure produced at many stages of the past and determined by past consumer values and past technological methods of production. There are different degrees of such past determinants built into the existing capital structure, and anyone starting today must use these resources as best he can to meet present and expected future goals. For these heterogeneous choices, no mathematical equations can be of the slightest use.[21]

Finally, the unique root of Mises's position, and one that distinguishes him and his "socialist impossibility" thesis from Hayek and the Hayekians, has been neglected until the present day. And this neglect has persisted despite Mises's own explicit avowal in his memoirs of the root and groundwork of his calculation thesis.[22] For Mises was *not*, like Hayek and his followers, concentrating on the flaws in the general equilibrium model when he arrived at his position; nor was he led to his discussion solely by the triumph of the socialist revolution in the Soviet Union. For Mises records that his position on socialist calculation emerged out of his first great work,

[21]Mises, *Human Action*, pp. 706–09. As Mises puts it: "socialists of all shades of opinion, repeat again and again that what makes the achievement of their ambitious plans realizable is the enormous wealth hitherto accumulated. But in the same breath they disregard the fact that this wealth consists to a great extent in capital goods produced in the past and more or less antiquated from the point of view of our present valuations and technological knowledge." Ibid., p. 710.

[22]In Mises's *Notes and Recollections* (Spring Mills, Penn.: Libertarian Press, 1978), p. 112. Also see the discussion in Murray N. Rothbard, *Ludwig von Mises: Scholar, Creator, Hero* (Auburn, Ala.: Ludwig von Mises Institute, 1988), pp. 35–38.

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The Theory of Money and Credit (1912). In the course of that notable integration of monetary theory and "micro" marginal utility theory, Mises was one of the very first to realize that subjective valuations of the consumers (and of laborers) on the market are purely ordinal, and are in no way measurable. But market prices are cardinal and measurable in terms of money, and market money prices bring goods into cardinal comparability and calculation (e.g., a $10 hat is "worth" five times as much as a $2 loaf of bread).[23] But Mises realized that this insight meant it was absurd to say (as Schumpeter would) that the market "imputes" the values of consumer goods back to the factors of production. Values are not directly "imputed"; the imputation process works only indirectly, by means of money prices on the market. Therefore socialism, necessarily devoid of a market in land and capital goods, must lack the ability to calculate and compare goods and services, and therefore any rational allocation of productive resources under socialism is indeed *impossible*.[24]

For Mises, then, his work on socialist calculation was part and parcel of his expanded integration of direct and monetary exchange, of "micro" and "macro," that he had begun but not yet completed in *The Theory of Money and Credit*.[25]

Fallacies of Hayek and Kirzner

The orthodox line of the 1930s and 40s was wrong in claiming that Hayek and his followers (such as Lionel Robbins) abandoned Mises's "theoretical" approach by bowing down to the Pareto-Barone equations, falling back on "practical" objections to socialist planning.[26] As we have already seen, Hayek scarcely ceded to mathematical equations of general equilibrium the monopoly of correct economic theory. But it is also true that Hayek and his followers fatally and radically changed the entire focus of their "Austrian" position, either by mis-

[23]On the market, then, consumers *evaluate* goods and services ordinally, whereas entrepreneurs *appraise* (estimate and forecast future prices) cardinally. On valuation and appraisement, see Mises, *Human Action*, pp. 327–330; Salerno, "Mises as Social Rationalist," pp. 39–49; and Salerno, "Socialist Economy is *Impossible*."

[24]Mises says in his memoirs: "They [the socialists] failed to see the very first challenge: How can economic action that always consists of preferring and setting aside, that is, of making unequal valuations, be transformed into equal valuations, by the use of equations? Thus the advocates of socialism came up with the absurd recommendation of substituting equations of mathematical catallactics, depicting an image from which human action is eliminated, for the monetary calculation in the market economy." Mises, *Notes and Recollections*, p. 112.

[25]This integration was later completed by his business-cycle theory in the 1920s, and then in his monumental treatise *Human Action*.

[26]Except for the unfortunate emphasis of Hayek and Robbins on the alleged socialist difficulty of computing or "counting" the equations. See below.

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construing Mises's argument or by consciously though silently shifting the crucial terms of the debate.

It is no accident, in short, that Hayek and the Hayekians dropped Mises's term "impossible" as embarrassingly extreme and imprecise. For Hayek, the major problem for the socialist planning board is its lack of *knowledge*. Without a market, the socialist planning board has no means of knowing the value-scales of the consumers, or the supply of resources or available technologies. The capitalist economy is, for Hayek, a valuable means of disseminating knowledge from one individual to another through the pricing "signals" of the free market. A static, general equilibrium economy would be able to overcome the Hayekian problem of dispersed knowledge, since eventually all data would come to be known by all, but the everchanging, uncertain data of the real world prevents the socialist planning board from acquiring such knowledge. Hence, as is usual for Hayek, the argument for the free economy and against statism rests on an argument from ignorance.

But to Mises the central problem is not "knowledge." He explicitly points out that *even if* the socialist planners knew perfectly, and eagerly wished to satisfy, the value priorities of the consumers, and *even if* the planners enjoyed a perfect knowledge of all resources and all technologies, they *still* would not be able to calculate, for lack of a price system of the means of production. The problem is not knowledge, then, but calculability. As Professor Salerno points out, the *knowledge* conveyed by present—or immediate "past"—prices is consumer valuations, technologies, supplies, etc. of the immediate or recent past. But what acting man is interested in, in committing resources into production and sale, is *future* prices, and the present committing of resources is accomplished by the entrepreneur, whose function is to *appraise*—to anticipate—future prices, and to allocate resources accordingly. It is precisely this central and vital role of the *appraising entrepreneur*, driven by the quest for profits and the avoidance of losses, that cannot be fulfilled by the socialist planning board, for lack of a market in the means of production. Without such a market, there are no genuine money prices and therefore no means for the entrepreneur to calculate and appraise in cardinal monetary terms.

More philosophically, the entire Hayekian emphasis on "knowledge" is misplaced and misconceived. The purpose of human action is not to "know" but to employ means to satisfy goals. As Salerno perceptively summarizes Mises's position:

> The price system is not—and praxeologically cannot be—a mechanism for economizing and communicating the knowledge relevant to production plans [the Hayekian position]. The realized prices of history are an accessory of appraisement, the mental operation in

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> which the faculty of understanding is used to assess the quantitative structure of price relationships which corresponds to an anticipated constellation of economic data. Nor are anticipated future prices tools of knowledge; they are instruments of economic calculation. And economic calculation itself is not the means of acquiring knowledge, but the very prerequisite of rational action within the setting of the social division of labor. It provides individuals, whatever their endowment of knowledge, the indispensable tool for attaining a mental grasp and comparison of the means and ends of social action.[27]

In a recent article, Professor Israel Kirzner argues for the Hayekian position. For Hayek and for Kirzner, the market is a "discovery procedure," that is, an unfolding of knowledge. There is, in this view of the market and of the world, no genuine recognition of the entrepreneur, not as a "discoverer," but as a dynamic risk taker, risking losses if his appraisal and forecast go awry. Kirzner's commitment to the "discovery process" fits all too well with his own original concept of the entrepreneurial function as being that of "alertness," and of different entrepreneurs as being variously alert to the opportunities that they see and discover. But this outlook totally misconceives the role of the entrepreneur. The entrepreneur is not simply "alert"; he forecasts; he appraises; he meets and bears risk and uncertainty by questing for profits and risking losses. As Salerno points out, for all their talk of dynamism and uncertainty, the Hayek-Kirzner "entrepreneur" is curiously bloodless and passive, receiving and passively imbibing knowledge imparted to him by the market. The Hayek-Kirzner entrepreneur is far closer than they like to think to the Walrasian automaton, to the fictional "auctioneer" who avoid all real trades in the marketplace.[28]

Unfortunately, while lucidly expounding the Hayekian position, Kirzner obfuscates the history of the debate by claiming that the later Mises, along with Hayek, changed his position (or, at the least, "elaborated" it) from his original, "static" view of 1920. But on the contrary, as Salerno points out, the "later" Mises explicitly spurned

[27]Salerno, "Mises as Social Rationalist," p. 44.

[28]Israel M. Kirzner, "The Economic Calculation Debate: Lessons for Austrians," *Review of Austrian Economics* 2 (1988): 1–18. Hayek coined the term "discovery procedure" in F. A. Hayek, "Competition as a Discovery Procedure," in *New Studies in Philosophy, Politics, Economics and the History of Ideas* (Chicago: University of Chicago Press, 1978), pp. 179–90. For a critique of Kirzner's concept of entrepreneurship, see Murray N. Rothbard, "Professor Hébert on Entrepreneurship," *Journal of Libertarian Studies* 7 (Fall 1985): 281–85. For Hayek's own contributions to the socialist calculation debate after Lange-Lerner, see F. A. Hayek, "Socialist Calculation III: The Competitive 'Solution'" (1940), and "The Use of Knowledge in Society," (1945), in *Individualism and Economic Order*, pp. 181–208; 77–91.

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uncertainty of the future as the key to the calculation problem. The key to the calculation question, stated Mises in *Human Action*, is *not* that "all human action points to the future and the future is always uncertain." No, socialism has

> quite a different problem. Today we calculate from the point of view of our present knowledge and of our present anticipation of future conditions. We do not deal with the problem of whether or not the [socialist] director will be able to anticipate future conditions. What we have in mind is that the director cannot calculate from the point of view of his own present value judgments and his own present anticipation of future conditions, whatever they may be. If he invests today in the canning industry, it may happen that a change in consumers' tastes or in the hygienic opinions concerning the wholesomeness of canned food will one day turn his investment into a malinvestment. But how can he find out today how to build and equip a cannery most economically?
>
> Some railroad lines constructed at the turn of the century would not have been built if the people had at that time anticipated the impending advance of motoring and aviation. But those who at the time built railroads knew which of the various possible alternatives for the realization of their plans they had to choose from the point of view of their appraisements and anticipations and of the market prices of their day in which the valuations of the consumers were reflected. It is precisely this insight that the director will lack. He will be like a sailor on the high seas unfamiliar with the methods of navigation . . .[29,30]

Solving Equations and Lange's Last Word

One of the unfortunate formulations of Hayek and the Hayekians in the 1930s, giving rise to the general misunderstanding that the only problems of socialist planning are "practical" not "theoretical," was their stress on the alleged difficulty of socialist planners in computing or solving all the demand and supply functions, all the "simultaneous differential equations" needed to plan prices and the allocation of resources. If socialistic planning is to rely on the Pareto-Barone equations, then how will all of them be known, especially in a world of necessarily changing data of values, resources, and technology?

Lionel Robbins began this equation-difficulty approach in his

[29]Mises, *Human Action*, p. 696. Also see Salerno, "Mises as Social Rationalist," pp. 46–47ff.

[30]Kirzner apparently believes that Mises's concentration on entrepreneurship in his *Human Action* discussion of socialism demonstrates that Mises had gone over to the Hayek position. Kirzner seems to overlook the vast difference between Mises's forecasting and appraisement view of entrepreneurship and his own "alertness" doctrine, which totally leaves out the possibility of entrepreneurial loss.

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study of the 1929 depression, *The Great Depression*. Conceding, with Mises, that the planners could determine consumer preferences by allowing a market in consumer goods, Robbins correctly added that the socialist planners would also have to "know the relative efficiencies of the factors of production in producing all the possible alternatives." Robbins then unfortunately added:

> On paper we can conceive this problem to be solved by a series of mathematical calculations. We can imagine tables to be drawn up expressing the consumers' demands . . . And we can conceive technical information giving us the productivity . . . which could be produced by each of the various possible combinations of the factors of production. On such a basis a system of simultaneous equations could be constructed whose solution would show the equilibrium distribution of factors and the equilibrium production of commodities.
>
> But in practice this solution is quite unworkable. It would necessitate the drawing up of millions of equations on the basis of millions of statistical tables based on many more millions of individual computations. By the time the equations were solved, the information on which they were based would have become obsolete and they would need to be calculated anew.[31]

While Robbins's strictures about changes in data were and still are true enough, they helped divert the emphasis from Mises's even-if-static and full-knowledge calculation approach, to Hayek's emphasis on uncertainty and change. More important, they gave rise to the general myth that Robbins's strictures against socialism, unlike Mises's, were only "practical" in the sense of not being able to calculate all these simultaneous equations. Furthermore, in the concluding essay in his *Collectivist Economic Planning*, Hayek set forth all the reasons why the planners could not know essential data, one of which is that they would have to solve "hundreds of thousands" of unknowns. But

> this means that, at each successive moment, every one of the decisions would have to be based on the solution of an equal number of simultaneous differential equations, a task which, with any of the means known at present, could not be carried out in a lifetime. And yet these decisions would . . . have to be made continuously . . .[32]

It is fascinating to note the twists and turns in Oskar Lange's reaction to the equation-solving argument. In his 1936 article, which was long considered the last word on the subject, Lange ridiculed the

[31]Lionel Robbins, *The Great Depression* (New York: Macmillan, 1934), p. 151.

[32]F. A. Hayek, "The Present State of the Debate," in Hayek, *Collectivist Economic Planning*, p. 212.

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very terms of the problem. Adopting his "quasi-market" socialist approach, and ignoring the crucial Misesian problem of the necessary absence of any market in land or capital, Lange simply stated that there is no need for planners to worry about these equations, since they would be "solved" by the socialist market:

> Neither would the Central Planning Board have to solve hundreds of thousands . . . or millions . . . of equations. The only "equations" which would have to be "solved" would be those of the consumers and the managers of production plants. These are exactly the same "equations" which are solved in the present economic system and the persons who do the "solving" are the same also. Consumers . . . and managers . . . "solve" them by a method of trial and error . . . And only few of them have been graduated in higher mathematics. Professor Hayek and Professor Robbins themselves "solve" at least hundreds of equations daily, for instance, in buying a newspaper or in deciding to take a meal in a restaurant, and presumably they do not use determinants or Jacobians for that purpose.[33]

Thus, the orthodox neoclassical economic establishment had settled the calculation dispute with Lange-Lerner the acclaimed winner. Accordingly, when the end of World War II brought communism/socialism to his native Poland, Professor Oskar Lange left the plush confines of the University of Chicago to play a major role in bringing his theories to bear on the brave new world of socialist Poland. Lange became Polish ambassador to the United States, then Polish delegate to the United Nations Security Council, and finally chairman of the Polish Economic Council. And yet not once in this entire period or later, did Poland—or any other communist government, for that matter—attempt to put into practice anything remotely like Lange's fictive accounting-type, play-at-market socialism. Instead, they all put into effect the good old Stalinist command-economy model.

It did not take long for Oskar Lange to adjust to the persistence of the Stalinist Model. Indeed, it turns out that Lange, in post-war Poland, argued strongly for the historical necessity of the persistence of the Stalinist model as opposed to his own market socialism. Arguing

[33]Oskar Lange, "On the Economic Theory of Socialism, Part One," p. 67. The Norwegian economist and defender of Mises's position, Trygve Hoff, commented that "Quite apart from the fact that the equations the central authority would have to solve are of quite a different nature to those of the private individual, the latter tend to solve themselves automatically, which Dr. Lange must admit the former do not." Hoff, *Economic Calculation in the Socialist Society*, pp. 221–22. This excellent book on the socialist calculation controversy was originally published in Norwegian in 1938. In contrast to Bergson's almost contemporaneous survey article, Hoff's English-language translation, published in 1949 in Britain but not in the United States, sank without a trace.

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against his own quasi-decentralized market-socialist solution, Lange, in 1958, revealed that "in Poland, we had some discussions whether such a period of highly centralized planning and management was historical necessity or a great political mistake. Personally, I hold the view that it was a historical necessity."

Why? Lange now claimed:

(a) that the "very process of the social revolution which liquidates one social system and establishes another requires centralized disposal of resources by the new revolutionary state, and consequently centralized management and planning."

(b) second, in underdeveloped countries—and which socialist country was not underdeveloped?—"Socialist industrialization, and particularly very rapid industrialization, which was necessary in the first socialist countries, particularly in the Soviet Union . . . requires centralized disposal of resources." Soon, however, Lange promised, the dialectic of history will require the socialist government to organize quasi-market, decentralized decision-making within the overall plan.[34]

Shortly before his death in 1965, however, Oskar Lange, in his neglected last word on the socialist calculation debate, implicitly revealed that his socialist-market "solution" had been little more than a hoax, to be jettisoned quickly when he indeed saw a way for the Planning Board to solve all those hundreds of thousands or millions of simultaneous equations! Strangely gone was his gibe that everyone "solves equations" every day without having to do so formally. Instead, technology had now supposedly come to the rescue of the Planning Board! As Lange put it:

> Were I to rewrite my essay ["On the Economic Theory of Socialism"] today my task would be much simpler. My answer to Hayek and Robbins would be: so what's the trouble? Let us put the simultaneous equations on an electronic computer and we shall obtain the solution in less than a second. The market process with its cumbersome *tatonnements* appears old-fashioned. Indeed, it may be considered as a computing device of the pre-electronic age.[35]

Indeed, Lange claims that the computer is superior to the market, because the computer can perform long-range planning far better, since it somehow already knows "future shadow prices" which markets cannot seem to obtain.

[34]Oskar Lange, "The Role of Planning in Socialist Economy," in *The Political Economy of Socialism* (1958) in M. Bornstein, ed., *Comparative Economic Systems*, rev. ed. (Homewood, Ill.: Richard D. Irwin, 1969), pp. 170–71.

[35]Oskar Lange, "The Computer and the Market," in A. Nove and D. Nuti, eds. *Socialist Economics* (London: Penguin Books, 1972), pp. 401–02.

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Lange's naive enthusiasm for the magical planning qualities of the computer in its early days can only be considered a grisly joke to the economists and the people in the socialist countries who have seen their economies go inexorably from bad to far worse despite the use of computers. Lange apparently never became familiar with the computer adage, *GIGO* ("garbage in, garbage out"). Nor could he have become familiar with the recent estimate of a top Soviet economist that, even assuming that the planning board and its computers could learn the correct data, it would take even the current generation of computers 30,000 years to process the information and allocate the resources.[36]

But there is a more important flaw in Lange's last article than his naivete about the magical powers of the then-new technology of the computer. His eagerness to embrace a way of solving those equations he earlier had claimed didn't *need* conscious solving, demonstrates that he had been disingenuous in claiming that his pseudo-market trial-and-error method would provide a facile way for the socialist society to solve the calculation problem.

Socialist Impossibility and the Argument from Existence

Ever since 1917, or at least since Stalin's great leap forward into socialism in the early 1930s, the defenders of the possibility of socialism against Mises's strictures had one final, clinching, fallback argument. When all the arguments over general equilibrium or equations or entrepreneurship or Walrasian *tatonnements* or the command economy or pseudo-markets had been hashed over, the defenders of socialism could simply fall back on one point: Well, socialism exists, doesn't it? When all is said and done, it exists, and therefore it must be, for one reason or another, possible. Mises must clearly be wrong, even if the "practical" arguments of Hayek or Robbins, arguments of mere degrees of efficiency, need to be soberly considered. At the end of his celebrated survey essay on socialist economics Professor Abram Bergson put the point starkly:

> there can hardly be any room for debate: of course, socialism can work. On this, Lange certainly is convincing. If this is the sole issue, however, one wonders whether at this stage such an elaborate theoretic demonstration is in order. After all, the Soviet planned economy has been operating for thirty years. Whatever else may be said of it, it has not broken down.[37]

[36]Yuri M. Maltsev, "Soviet Economic Reform: An Inside Perspective," *The Freeman* (March 1990).

[37]Bergson, "Socialist Economics," p. 447.

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In the first place, this triumphal conclusion now rings hollow, since the economies of the Soviet Union and the other socialist bloc countries have now manifestly broken down. And now it also turns out that the Soviet GNP and production figures that Bergson, the CIA, and other Sovietologists have been taking at face value for decades have been nothing but a pack of lies, designed to deceive not the United States, but the Soviet managers' own ruling elite. Even now, Western Sovietologists are reluctant to believe the Soviet economists who are finally trying to tell them the truth about these alleged and much revered data.

But apart from all that, this sort of seemingly decisive empiricist counter to the Misesian critique reveals the perils of using allegedly simple and brute "facts" to rebut theory in the sciences of human action. For why must we assume that the Soviet Union and the Eastern European countries ever really enjoyed full and complete socialism? There are many reasons to believe that, try as they might, the communist rulers were never able to impose total socialism and central planning. For one thing, it is now known that the entire Soviet economy and society has been shot through with a vast network of black markets and evasions of controls, fueled by a pervasive system of bribery known as *blat* to allow escape from those controls. Managers who could not meet their annual production quotas were approached by illegal entrepreneurs and labor teams to help them meet the quotas and get paid off the books. And black markets in foreign exchange have long been familiar to every tourist. Long before the Eastern European collapse of communism, these countries stopped trying to stamp out their black markets in hard currency, even though they were blatantly visible in the streets of Warsaw, Budapest, and Prague. Without uncontrolled black markets fueled by bribery, the communist economies may well have collapsed long ago.[38] This historical point has also been bolstered by Michael Polanyi's "span of control" theory, which denies the possibility of effective central planning from a rather different viewpoint than Mises's.[39]

But the decisive rebuttal has, once again, been levelled by Mises in *Human Action*: the Soviet Union and Eastern European economies were not fully socialist because they were, after all, islands in a world capitalist market. The communist planners were therefore able, albeit clumsily and imperfectly, to use prices set by world markets as

[38]One source on this pervasive system in the Soviet Union is Konstantin M. Simis, *USSR: The Corrupt Society* (New York: Simon & Schuster, 1982).

[39]Michael Polanyi, *The Logic of Liberty* (Chicago: University of Chicago Press, 1951), pp. 111–37 and passim.

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indispensable guidelines for the pricing and allocation of capital resources. As Mises pointed out:

> People did not realize that these were not isolated social systems. They were operating in an environment in which the price system still worked. They could resort to economic calculation on the ground of the prices established abroad. Without the aid of these prices their actions would have been aimless and planless. Only because they were able to refer to these foreign prices were they able to calculate, to keep books, and to prepare their much talked about plans.[40]

Mises's insight was confirmed as early as the mid-1950s, when the British economist Peter Wiles visited Poland, where Oskar Lange was helping to plan Polish socialism. Wiles asked the Polish economists how they planned the economic system. As Wiles reported:

> What actually happens is that "world prices", i.e. *capitalist world prices*, are used in all intra-[Soviet] bloc trade. They are translated into rubles . . . entered into bilateral clearing accounts.

Wiles then asked the Polish communist planners the crucial question. Since the Poles were, as good Marxist-Leninists, presumably committed to the triumph, as soon as possible, of world-wide socialism, Wiles asked: "What would you do if there were no capitalist world" from which you could obtain all those crucial prices? The Polish planners' rather cynical answer: "We'll cross that bridge when we come to it." Wiles added that "In the case of electricity the bridge is already under their feet: there has been great difficulty in pricing it since there is no world market."[41] But fortunately for the world and for the Polish planners themselves, they were never truly forced to cross that bridge.

Epilogue: The End of Socialism and Mises's Statue

In his supposedly definitive article of 1936 vindicating economic calculation under socialism, Oskar Lange delivered a once-famous gibe at Ludwig von Mises. Lange began his essay by ironically hailing Mises's services to socialism: "Socialists have certainly good reason to be grateful to Professor Mises, the great *advocatus diaboli* of their cause. For it was his powerful challenge that forced the socialists to

[40]Mises, *Human Action*, pp. 698–99.

[41]Peter J. D. Wiles, "Changing Economic Thought in Poland," *Oxford Economic Papers* 9 (June 1957): 202–03. Also see Murray N. Rothbard, "Ludwig von Mises and Economic Calculation Under Socialism," in Lawrence Moss, *The Economics of Ludwig von Mises*, pp. 67–77.

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recognize the importance of an adequate system of economic accounting. . . . the merit of having caused the socialists to approach this problem systematically belongs entirely to Professor Mises." Lange then went on to taunt Mises:

> Both as an expression of recognition for the great service rendered by him and as a memento of the prime importance of sound economic accounting, a statue of Professor Mises ought to occupy an honorable place in the great hall of the Ministry of Socialization or of the Central Planning Board of the socialist state.

Lange went on to say that "I am afraid that Professor Mises would scarcely enjoy what seemed the only adequate way to repay the debt of recognition incurred by the socialists . . ." For one thing, Lange concluded, to complete Mises's discomfiture

> a socialist teacher might invite his students in a class on dialectical materialism to go and look at the statue, in order to exemplify the Hegelian *List der Vernuft* [cunning of Reason] which made even the staunchest of *bourgeois* economists unwittingly serve the proletarian cause.[42]

Curiously enough, Lange, during his years as socialist planner in Poland, never got around to erecting the statue to Mises at the Ministry of Socialization in Warsaw. Perhaps socialist planning was not successful enough to accord Mises that honor—or perhaps there were not enough resources to build the statue. In any case, the opportunity has been lost. The countries of Eastern Europe now stand in the rubble wrought by what used to be called in the 1930s "the great socialist experiment." Emerging gloriously out of the rubble of the collapse of socialism are a myriad of Misesian economists, to whom socialism is little more than a grisly joke. Even as early as the 1960s it was a common quip among economists that, at international economic conferences, "the Western economists talk about the glories of planning while the Eastern economists talk about the virtues of the free market." Now Misesian economists are springing out of the ruins of socialism in Poland, Lithuania, Czechoslovakia, Hungary, Yugoslavia (especially Croatia and Slovenia) and the Soviet Union. Neither socialist planning nor Marxism-Leninism hold any charms for the economists of the once-socialist nations.

In all of these countries, the giant statues of Lenin are being unceremoniously toppled from the public squares. Whether or not the coming free societies of Eastern Europe choose to replace them with statues of Ludwig von Mises, as the prophet of their liberation, one

[42]Lange, "The Economic Theory of Socialism," p. 53.

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thing seems certain: there will be no statues erected to Oskar Lange in Cracow or Warsaw. It is hard to see how even the cunning of Reason and the Hegelian dialectic can make Lange out to be a prophet or an important contributor to the laissez-faire Polish economy of the future. Perhaps the closet approach was a bitter quip pervading Eastern Europe during the revolutionary year of 1989: "Communism can be defined as the longest route from capitalism to capitalism."

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De-Socialization in a United Germany

Hans-Hermann Hoppe*

I

As a result of the defeat of Hitler's Germany in Word War II, there were 10 million refugees living on a significantly reduced German territory; 40 percent of the population was bombed-out (the population of Cologne, for instance, had declined from 750,000 to 32,000) and 60 percent was undernourished.[1]

In those territories occupied by the Western Allies, initially the economic system inherited from the Nazi regime—a command-war-economy—was retained. Almost all consumer goods were rationed, all-around price and wage controls remained in effect, and imports and exports were strictly regulared by the military administration. Black markets and barter trade were ubiquitous. Due to general price maxima and an expansionary supply of paper Reichs marks, no goods were to be found and money was largely useless.[2] Black-market prices experienced a highly inflationary development and substitute currencies like coffee, cigarettes, and butter emerged. German output in 1946 was less than one-third of what it had been in 1938. Chaos and desperation were the mark of the day.

In respone to the beginning Cold War between the Allies, in particular the United States and the Soviet Union, the Western

*Hans-Hermann Hoppe is associate professor of economics at the University of Nevada, Las Vegas..

[1]For details see Gustav Stolper, *German Realities* (New York: Reynal & Hitchcock, 1948); Frank Grube and Gerhard Richter, *Die Schwarzmarktzeit: Deutschland zwischen 1945 und 1948* (Hamburg, 1979); Theodor Eschenburg, *Jahre der Besatzung 1945–1949* (Stuttgart, 1983); Charles Kindleberger, *The German Economy, 1945–1947: Charles Kindleberger's Letters from the Field* (Westport, Conn.: Meckler, 1989) with a historical introduction by Günther Bischof.

[2]On the phenomenon of repressed inflation see Wilhelm Röpke, *Die Lehre von der Wirtschaft* (Bern, 1979), pp. 142–45; idem, "Repressed Inflation," *Kyklos* 1, no. 3 (1947); for a purely theoretical treatment of the phenomenon see Murray N. Rothbard, *Power and Market* (Kansas City: Sheed Andrews & McMeel, 1977), pp. 28–29.

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Powers in 1947 changed their policy toward Germany. While their previous goal had been the de-industrialization of Germany—the industrial production was supposed to be frozen at 50–55 percent of Germany's 1938 output level—so as to permanently impoverish the German population, it was now decided to further the economic reconstruction of the Western occupied territories in order to build up an economic power base for the new strategy of *containment* and *roll back*.[3]

From 1948 through 1952 the three Western zones received $1.5 billion in Marshall aid. More importantly, in May of 1947 the British and American occupied zones were merged, and the economic administration of the unified region was largely put back into German hands, and on March 2, 1948, Ludwig Erhard, former economic minister of Bavaria, was elected director. Erhard, whose economic philosophy had been heavily influenced by the neo-liberal Freiburg school of Walter Eucken and Franz Böhm, which had in turn been influenced by the Austrian school of Ludwig von Mises,[4] initiated a currency reform on June 20, 1948, and consequently pursued a hard-money policy. As long as the monopoly of note issue rested with the Allies—who had set up a central banking system modeled after the United States Federal Reserve—the money supply remained drastically expanded (by more than 150 percent), with almost

[3]On the Cold War and the international dimensions of Germany's post World War II development see Paul Johnson, *Modern Times* (New York: Harper & Row, 1983), chaps. 13 and 17; Paul Kennedy, *The Rise and Fall of the Great Powers* (New York: Random House, 1987), chap. 7.

[4]See Ludwig Erhard, *Wohlstand für Alle* (Düsseldorf, 1957; updated edition 1990); idem, *Deutsche Wirtschaftspolitik* (Düsseldorf, 1967). Erhard's closest direct advisor was Alfred Müller-Armack, *Wirtschaftslenkung und Marktwirtschaft* (Hamburg, 1947). Walter Eucken's most influential works are *Die Grundlagen der Nationalökonomie* (Jena, 1940) and *Grundsätze der Wirtschaftspolitik* (Hamburg, 1959); for Franz Böhm see his *Reden und Schriften*, ed. E.S. Mestmäcker (Karlsruhe, 1960) and "Privatrechtsgesellschaft und Marktwirtschaft," *Ordo* 17 (1966). The annual *Ordo* is the main organ of the Freiburg School. Of similar influence were Wilhelm Röpke: *Die Lehre von der Wirtschaft* (Bern, 1979), *Die Gesellschaftskrisis der Gegenwart* (Erlenbach-Zürich, 1948), *Jenseits von Angebot und Nachfrage* (Erlenbach-Zürich, 1957), and Alexander Rüstow: *Ortsbestimmung der Gegenwart*, 3 vols. (Erlenbach-Zürich: Eugen Rentsch, 1950, 1952 and 1957). The influence of Ludwig von Mises was mostly through his *Theory of Money and Credit*, H. E. Batson, trans. (1912; London: Jonathan Cape, 1934), *Nation, State, and Economy*, Leland B. Yeager, trans. (1919; New York: New York University Press, 1983), *Socialism: An Economic and Sociological Analysis*, J. Kahane, trans. (1922; Indianapolis, Ind.: Liberty Fund, 1981), *Liberalism*, Ralph Raico, trans. (1927; Princeton, N.J.: D. Van Nostrand, 1962), and *Human Action: A Treatise on Economics*, 3rd ed. (1949; Chicago: Henry Regnery, 1966). On the relationship between these and other strands of free market thought see Friedrich A. Hayek, *Studies in Philosophy, Politics and Economics* (Chicago: University of Chicago Press, 1957), chap. 13.

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immediate inflationary consequences. However, after October 1948 a continuously tight monetary policy was put into effect (in the beginning, the minimum reserve requirements and the discount rate were actually raised, while taxes were lowered), which quickly established West Germany as one of the world's least inflationary countries and the deutsche mark as one of the hardest currencies (during this 13-year period from 1948-1961 the consumer price index rose by a 'mere' 14 percent).

More importantly, contrary to the advice of American and British economic experts, who were taken completely by surprise, and against the prevailing public opinion in Germany, on June 24, 1948, only 4 days after the currency reform, Ludwig Erhard implemented a radical—although by no means flawless[5]—free-market reform. In accordance with the precepts of the 'new' Keynesian economics and the practice of the ruling British Labor Party, foreign experts and German public opinion had favored a policy of macro-economic management, of socialized investment, and a sector of nationalized 'basic' industries.[6] Instead, with one stroke Erhard abolished almost all price and wage controls and allowed almost complete freedom of movement, trade and occupation, thus radically expanding the rights of *private*-property owners.[7]

Less than one year later, on May 23, 1949, the Federal Republic of Germany (FRG) was founded and the framework of the *soziale Marktwirtschaft* (Socialist Market Economy) created by Ludwig Erhard, became ratified as West Germany's economic constitution.[8]

From the outset, the development in the Soviet-occupied territories of Germany took a different course.[9] In 1945, with its first order,

[5]On this see p. 87 ff below.

[6]The leading American economic advisors, for instance, were the "new-dealers" and free-market foes Charles P. Kindleberger, John K. Galbraith, and Walt W. Rostow. Indicative of the German public opinion is the fact that even the newly founded conservative Christian Democratic Union, in its Ahlen Program of 1947, stated that "the capitalist economic system has not done justice to the vital interests of the German people in state and in society" and accordingly demanded large-scale socialization policies.

[7]The U.S. high commissioner, General Lucius D. Clay, reacted to Erhard's liberalization plans by saying: "My advisors tell me they are much opposed to this." Erhard replied: "Never mind, General, mine are telling me the same thing."

[8]On the development of West Germany's economic system up to the mid-1960s see the generally excellent study by Hans-Joachim Arndt, *West Germany: Politics of Non-Planning* (Syracuse: Syracuse University Press, 1966).

[9]For comparative economic analyses of East and West Germany see H. Winckel, *Die Wirtschaft im geteilten Deutschland 1945–1970* (Wiesbaden, 1974); Karl Thalheim, *Die wirtschaftliche Entwicklung der beiden Staaten in Deutschland* (Opladen, 1978);

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the Soviet Military Administration nationalized all banks. In the same year, all farms of more than 250 acres were seized (50 percent of all land used for agriculture), and all property of actual and alleged Nazis and war criminals was confiscated. When on November 7, 1949,—a few months after the Western Allies had licensed the new West German government—the new East German state (GDR) received its license from the Soviet Union, the Soviet practice of large-scale expropriation was elevated to a constitutional principle: "The economy of the German Democratic Republic is a planned socialist economy."[10] By 1960, more than 90 percent of all agricultural land was in the hands of socialized producer co-ops. By 1950, more than 60 percent of all productive output was produced in socialized firms. By 1960, more than 80 percent of East German output originated from socialized production; and by the early 1970s the expansion of the socialized sector had reached 95 percent (i.e., a mere 5 percent of productive output originated in state-licensed private enterprises).[11]

In addition, from 1945 through 1953, during the Stalin era, East Germany was forced to pay heavy reparations (45 percent of the productive equipment of 1945 was dismantled and confiscated by the Soviets vs. 8 percent in the West). To facilitate centralized economic planning, a one-stage central banking system was set up. The central bank became the monopolistic note issuer and central commercial bank at the same time, with regional and local banks as its branches (rather than separating both functions and leaving the commercial banking function in private hands, as in West Germany and the United States). Three days after the West German currency reform, on June 23, 1948, a new East German currency—initially with an official 1:1 exchange rate against West Germany's deutsche mark—was introduced. However, a continuing policy of monetary expansion, combined with price maxima for all 'basic' consumer goods, quickly led back to the phenomenon of "repressed inflation," i.e., an excess supply of anesthetized money. In response, in 1957 a second currency reform was carried out: All banknotes in excess of 300 East marks per person were declared invalid. But to no avail: the excess supply

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E. Jesse, ed., *BRD und DDR* (Berlin, 1982); Hannelore Hamel, ed., *Bundesrepublik Deutschland-DDR: Die Wirtschaftssysteme* (Munich, 1983); also: E. Windmöller and T. Höpker, *Leben in der DDR* (Hamburg, 1976).

[10]German Democratic Republic constitution, para. 9, sect. 3.

[11]Interestingly, the speed of East German socialization was significantly *slower* than in all the other Soviet-licensed states of Eastern and Central Europe except for Poland, where agriculture remained largely in private hands. See Jürgen Hartmann, *Politik und Gesellschaft in Osteuropa* (Frankfurt/M., 1983), p. 169.

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of money again swelled to an estimated 150 billion Marks (about 10,000 per person). The steady supply of anesthetized money entered the black, private markets, where prices drastically increased and the East German currency continually depreciated against the deutsche mark. Increasingly, the deutsche mark outcompeted the East mark as a medium of exchange on the black markets ("good money drives out bad") and soon became East Germany's second currency: its unofficial but "real" money.

From 1949, at which time the West and East German states were founded, until the dramatic events of 1989, a controlled social experiment was conducted. A homogeneous population, with a common history, culture, character structure, work ethic and above all language, was subject to two fundamentally different economic constitutions and institutional incentive structures.

II

The difference in the results has been striking. Yet no social experiment was necessary to find this out. Naturally not all empirical details, but the fundamental outcome of the German experiment could have been predicted with certainty by those familiar with the principles of economic theory, and in particular the theoretical economic analyses of socialism by the Viennese (Austrian) school, most notably Ludwig von Mises's. In his famous *Die Gemeinwirtschaft: Untersuchungen über den Sozialismus*, of 1922,[12] Mises irrefutably demonstrated what the East Germans were forced to find out the hard way: that socialism must end in disaster.

Wealth can be brought into existence or increased in three and only three ways: by perceiving certain nature-given things as scarce and actively bringing them into one's possession before anyone else has seen and done so (homesteading); by producing goods with the help of one's labor and such previously appropriated resources; or by acquiring a good through voluntary, contractual transfer from a previous appropriator or producer. Acts of original appropriation turn something which no one had previously perceived as a possible source of income into an income-providing asset; acts of production are by their very nature aimed at the transformation of a less valuable asset into a more valuable one; and every contractual exchange concerns the exchange and redirection of specific assets from the hands of those

[12]The first English translation appeared in 1936 under the title *Socialism: An Economic and Sociological Analysis*. The latest edition was published in 1981 by Liberty Fund. See also Mises's *Human Action*, chaps. 25 and 26, in which he provides a definitive answer to criticisms of his earlier work.

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who value their possession less to those who value them more.

From this it follows that socialism cannot but lead to impoverishment:[13]

(1) Under socialism, ownership of productive assets is assigned to a collective of individuals regardless of each member's prior actions or inactions in relation to the owned assets. In effect, then, socialist ownership favors the non-homesteader, the non-producer, and the non-contractor and disadvantages homesteaders, producers, and contractors. Accordingly, there will be less original appropriation of natural resources whose scarcity is realized, there will be less production of new and less upkeep of old factors of production, and there will be less contracting. All of these activities involve costs. Under a regime of collective ownership the costs of performing them is raised, and that of not performing them is lowered.

(2) Since means of production cannot be sold under socialism, no market prices for factors of production exist. Without such prices, cost-accounting is impossible. Inputs cannot be compared with outputs; and it is impossible to decide if their usage for a given purpose has been worthwhile or has led to a squandering of scarce resources in the pursuit of projects with relatively little or no importance for consumers. By not being permitted to take any offers from private individuals who might see an alternative way of using some given means of production, the socialist caretaker of capital goods simply does not know what his foregone opportunities are. Hence, permanent misallocations of production factors must ensue.

(3) Even *given* some initial allocation, since input factors and the output produced are owned collectively, every single producer's incentive to increase the quantity and/or quality of his individual output is systematically diminished; and likewise, his incentive to use input factors so as to avoid their over- or under-utilization is reduced. Instead, with gains and losses in the socialist firm's capital- and sales-account socialized instead of attributed to specific, individual producers, everyone's inclination toward laziness and negligence is systematically encouraged. Hence, an inferior quality and/or quantity of goods will be produced and permanent capital consumption must ensue.

(4) Under a regime of private property, the person who owns a resource can determine independently of others what to do with it. If

[13]See also Hans-Hermann Hoppe, *A Theory of Socialism and Capitalism: Economics, Politics, and Ethics* (Boston: Kluwer Academic Publishers, 1989); idem, "Why Socialism Must Fail," in Llewellyn H. Rockwell, ed., *The Free Market Reader* (Burlingame, Calif.: Ludwig von Mises Institute, 1988).

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he wants to increase his wealth and/or rise in social status, he can only do so by better serving the most urgent wants of voluntary consumers through the use that he makes of his property. With collectively owned factors of production, collective decision-making mechanisms are required. Every decision as to what, how and for whom to produce, how much to pay or charge, and who to promote or demote, is a political affair. Any disagreement must be settled by superimposing one person's will on another's view, and this invariably creates winners and losers. Hence, if one wants to climb the ladder under socialism, one must resort to one's political talents. It is not the ability to initiate, to work, and to respond to the needs of consumers that assures success. Rather, it is by means of persuasion, demagoguery, and intrigue, through promises, bribes, and threats that one rises to the top. Needless to say, this politicalization of society, implied in any system of collectivized ownership, contributes even more to impoverishment.

The German experiment provides the sad illustration for the validity of economic theory.

Erhard's free-market reforms quickly generated what has become known as the West German *Wirtschaftswunder* (economic miracle). After a short—and unsurprising—increase of unemployment, peaking at a rate of 8 percent in 1950, unemployment began steadily to decrease. By 1962, at the height of the Erhard era, the unemployment rate had fallen to 0.2 percent, and the number of employed persons had increased by some 8 million (more than 60 percent). The total wage sum tripled during the period from 1948–1960, and wage rates more than doubled in constant terms. In the same time, total industrial production increased fourfold, GNP per capita tripled, and the West German rate of economic growth far surpassed that of all other West European nations and the United States. By the early 1960s, West Germans ranked among the world's most prosperous people, and West Germany had become one of the foremost industrial nations, with products made in West Germany increasingly in demand worldwide (in 1960 West German exports made up 10 percent of world exports: nearly twice the world market share of 1937).[14]

Predictably, the economic development of East Germany took the opposite direction. After 40 years of West German *soziale Marktwirtschaft* versus East German socialism, the visitor going from West to East enters an almost completely different and impoverished world. Life is characterized by permanent shortages of all sorts of consumer goods (from meat to housing), endless mismatches

[14]See Ludwig Erhard, *Wohlstand für Alle*.

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of complementary factors of production, an inferior, shoddy quality of almost everything produced, and a pervasive black market struggling to alleviate the mess created by the official economy. Indicators of misallocation and capital consumption are omnipresent. Insufficiently maintained, deteriorating, unrepaired, and rusting property is common, and vandalism of production factors, machinery, and buildings is rampant. Within the official economy, negligence, laziness, despair, cynicism and sheer incompetence abound, and widespread hidden unemployment exists. Environmental damage has at many places reached catastrophic dimensions (socialization of negative externalities). Economic illiteracy among the population is pervasive. In world export markets East Germany is reduced to the rank of a third-world country that cannot sell anything except raw materials, half-finished products, or basic, simple consumer goods.

In the mid-1950s the East German per capita consumption already lagged an estimated 40 percent behind West Germany's. In the late 1980s, average wage income in East Germany was less than half of that in West Germany assuming a 1:1 currency exchange rate, and less than 1/10th if, more realistically, the black-market exchange rate between the East mark and deutsche mark is taken as the conversion ratio. Nominally, the average wage income in East Germany was somewhat lower—and in real terms more than 5 times lower—than the typical *unemployment subsidy* in West Germany. Nominally, average old age pensions in East Germany were 3 times—and in real terms 15 times—lower than in West Germany; and East Germany's minimum welfare handouts were nominally nearly 50 percent—actually more than 7 times—less than those paid in the West.

However, most revealing is the voting-by-feet-statistic: While all socialist countries of Eastern Europe have been plagued by the emigration problem of people wanting to leave for the more prosperous West, and while they all gradually had to establish tighter border controls in order to prevent this outflow, the case of Germany is a most striking one. With language differences, traditionally the most severe natural barrier for emigrants, nonexistent and West Germany automatically granting citizenship to all East German immigrants, the difference in living standards between the two Germanys proved to be so great that East Germany was from its very inception confronted with a massive wave of emigration. Following the industrial revolts of 1953, and their suppression by the occupying Soviet military forces, emigration reached such proportions—more than 3.5 million individuals had already deserted the East and this number increased by more than 1,000 per day—that on August 13, 1961 the

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socialist regime in East Germany desperately had to close its borders to the West. To keep its population in, it erected a containment system the likes of which the world has never seen. A system of walls, barbed wire, electrified fences, mine fields, automatic shooting devices, and watchtowers almost 900 miles long were constructed, for the sole purpose of preventing the East Germans from running away from socialism. From 1961–1989 the problem was thus contained. However, beginning in the summer of 1989, when socialist Hungary began to open its border to Austria, and even more so since the dismantling of the East German wall in November of 1989, the wave of East German emigration immediately resumed. Since then, each day more then 2,000 East Germans have packed and left socialism behind.[15]

[15]It is interesting to note how American comparative economic systems textbooks have treated the case of East versus West Germany. Apart from ignoring migration statistics and not mentioning the "Wall" at all, or merely in passing, they rely almost exclusively on official government statistics. Based on these they reach conclusions which can only be called perverse, and illustrate at best that economic statistics have very little to do with reality as perceived by acting individuals. The most scandalous example of this is Andrew Zimbalist, Howard J. Sherman and S. Brown, *Comparing Economic Systems* (New York: Harcourt Brace Jovanovich, 1989). After mentioning that from the outset East Germany was relatively disadvantaged by having to pay heavy reparations and because of massive population losses (but why did it lose its population?) they write: "During the 1950s, the economy of West Germany grew at a rate close to 7 percent while—in spite of its initial disadvantages—the growth rate for the East German economy was around 6.5 percent. On a GNP per capita basis, between 1960 and 1979 West Germany grew at 3.3 percent per year and East Germany grew at 4.7 percent. In West Germany real GNP grew by 1.8 percent in 1980 and fell by 0.3 percent in 1981; in East Germany, real national income grew by 4.2 percent in 1980 and increased by 4.5 percent in 1981. Thus, according to CIA estimates. . . . East German per capita income had risen to 87.6 percent of West German per capita income. The gap continued to narrow during 1982 and the first half of 1983. The conclusion appears uncontestable that over the entire post-war period East Germany has experienced more rapid growth per head than West Germany" (p. 468). Further, there was "a stronger *dynamic* efficiency in East Germany. . . . in West Germany the average annual increase in total factor productivity was 3.0 percent, and in East Germany it was 3.4 percent." Moreover, "East Germany has had greater economic stability [i.e. 'absence of excessive inflation and unemployment'] throughout the post-War period" (p. 469). In addition, while the "environmental quality is superior in West Germany," East Germany has less than half of the former's income inequality and "in all areas of life [East German] women have achieved a much higher degree of equality with men than have their counterparts in West Germany" (p. 470).

After reading this one must surely wonder why people did not move from West to East, and why an economic success story such as East Germany's ended with its total collapse! But the authors have an answer to this: "Finally, although we have been concerned only with economic performance, it is difficult to overlook the more desirable democratic political system in West Germany" (p. 470). Not much better is the analysis by P. R. Gregory and G. C. Stuart, *Comparative Economic Systems* (Boston: Houghton Mifflin, 1985), pp. 402–14. Largely irrelevant is also the earlier study by Wolfgang F. Stolper, *The Structure of the East German Economy* (Cambridge: Harvard University Press, 1960).

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III

While the underlying cause for the collapse of the East German socialist experiment in 1989 was economic, there is little doubt that Gorbachev's policy of *glasnost* and *perestroika* in the Soviet Union during the second half of the 1980s served as the catalyst for the revolutionary developments currently taking place in Germany and across Eastern Europe. This policy reduced the Soviet Union's pressure on its East European satellite states, in particular since from the outset Gorbachev's new internal policies had been explicitly connected to a non-interventionist foreign policy, and at the same time it dramatically uplifted the hopes and expectations of all East European people. Without this special constellation of data, created by Gorbachev, neither the peaceful anti-communist revolution in Poland nor the liberalization of Hungary would have been possible; and without the Polish and Hungarian events neither the East German nor the Czechoslovakian revolution would have followed.

Ultimately, Gorbachev must also be credited for the move towards reunification of East and West Germany. On the forever memorable November 9, 1989, steadily increasing pressures of mass emigration and civil unrest burst the East German socialist bubble, the borders to West Berlin and West Germany had to be thrown open, and the Germans of East and West reunited, moved and overjoyed, on top of the Berlin Wall. Since that date there has been no question of two separate German States. Public opinion in East and West overwhelmingly demanded reunification.

The economic dynamic set in motion by the events of November 9th succeeded in burying any remaining hopes within the East German regime of somehow restoring a separate socialist East German state. The uninterrupted mass flight of highly qualified personnel and unceasing internal unrest sharply aggravated East Germany's already desperate economic situation. Within a few days, the East mark depreciated against the deutsche mark from a ratio of 5:1 to 10:1, and only two reasons prevented it from becoming completely worthless. First, with increasingly open borders, for a short period of time holders of East marks could buy a number of maximum price controlled products in East Germany and profitably resell them in the West. Once the already sparsely decorated East German shelves were thus emptied and fewer or no new supplies were forthcoming, only one other reason remained: the public expectation that as part of the inevitable process of German reunification the West German central bank would eventually redeem East marks at some arbitrarily overvalued rate into deutsche marks.

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Different but related economic problems emerged in West Germany. While during the 1950s and 1960s the West German economy successfully integrated millions of East German refugees and Southern European "guest workers," the economy of the 1980s was severely strained by the latest wave of immigration. For from 1950 until the 1980s, the West German economy experienced a gradual transformation. Over time, Erhard's free-market Germany changed into a gigantic welfare state, and the early West German economic expansionism was replaced by economic stagnation.

From the outset Erhard's free-market reforms had been far from pure.[16] He had not introduced a *Marktwirtschaft*, but a *soziale Marktwirtschaft*, and theoretical observers such as Ludwig von Mises had warned early—prophetically—that this concession to a *social* economy would ultimately lead to welfare state socialism.[17] As the successor of the German Reich, the West German state immediately became West Germany's biggest real-estate owner, capitalist, and employer. Education, traffic, communication, schools, universities, streets, rivers, lakes, railroads, airlines, mail, telephone, radio, and

[16]See also Hans-Joachim Arndt, *West Germany: Politics of Non-Planning*, chap. 3.

[17]The supporters of "the German 'soziale Marktwirtschaft'," writes Mises, "stress that they consider the market economy to be the best possible and most desirable system of society's economic organization, and that they are opposed to the government omnipotence of socialism. But, of course, all these advocates of a middle-of-the-road policy emphasize with the same vigor that they reject Manchesterism and laissez-faire liberalism. It is necessary, they say, that the state interfere with the market phenomena whenever and wherever the 'free play of the economic forces' results in conditions that appear as 'socially' undesirable. In making this assertion they take it for granted that it is the government that is called upon to determine in every single case whether or not a definite economic fact is to be considered as reprehensible from the 'social' point of view and, consequently whether or not the state of the market requires a special act of government interference."

"All these champions of interventionism fail to realize that their program thus implies the establishment of full government supremacy in all economic matters and ultimately brings about a state of affairs that does not differ from what is called the German or the Hindenburg pattern of socialism. If it is in the jurisdiction of the government to decide whether or not definite conditions of the economy justify its intervention, no sphere of operation is left to the market. Then it is no longer the consumers who ultimately determine what should be produced, in what quantity, of what quality, by whom, where, and how—but it is the government. For as soon as the outcome brought about by the operation of the unhampered market differs from what the authorities consider 'socially' desirable, the government interferes. That means the market is free as long as it does precisely what the government wants it to do. It is 'free' to do what the authorities consider to be the 'right' things, but not to do what they consider the 'wrong' things; the decision concerning what is right and what is wrong rests with the government. Thus the doctrine and the practice of interventionism ultimately tend to abandon what originally distinguished them from outright socialism and to adopt entirely the principles of totalitarian all-round planning" (*Human Action: A Treatise on Economics*, pp. 723–24).

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television were in government hands and were soon complemented by a newly founded conscription army. All banks were cartelized within a government-controlled central banking system. Bismarck's compulsory social security system was resurrected and remained under government control. Housing and agriculture were largely left outside of and protected from markets. Mining, coal, steel, shipbuilding, and textiles were accorded special government protection. Beginning with the Co-Determination Law of 1951 and the Commercial Constitution Law' (*Betriebsverfassungsgesetz*) of 1952, a series of so-called labor-protection laws were introduced (including subsidies to unemployment and compulsory collective bargaining), which increasingly limited the right of freedom of contract in employer-employee relations. With the deceptive "law against restrictions of competition" (*Anti-Kartell Gesetz*) of 1957, the basic principle of market competition—of free and unrestricted entry—was largely suspended, and all 'significant' economic developments were subject to government approval.[18] All the while, the West German government could not resist the temptation to steadily increase taxes and the supply of paper money. Consequently, in 1966 West Germany experienced its first major recession, putting an end to Erhard's career, who by then had become chancellor. Economic growth fell from 9 percent in 1960 to 2 percent in 1966 and was negative in 1967. For the first time in over a decade the number of unemployed rose (to 2 percent).

In the post-Erhard era, in particular during the period from 1969-1982 under the reign of a social-democratic-liberal government coalition led by Willy Brandt and Helmut Schmidt, the welfare-statist transformation of the West German economy proceeded at an accelerated rate.[19] From 1969–1975 alone, some 140 laws were passed that entitled various 'socially disadvantaged' groups to tax subsidies. The

[18]While the Freiburg School, and in particular Röpke, recognize that in practice monopolies are almost always the creation of state power (see Wilhelm Röpke, *Die Lehre von der Wirtschaft*, p. 215; for a typical Freiburg treatment see Erich Hoppmann, *Fusionskontrolle* [Tübingen, 1972]), they admit (in agreement with neo-classic orthodoxy) the theoretical possibility of exploitative free-market monopolies and advocate a kind of compulsory anti-merger, and allegedly pro-small business legislation to combat their emergence. For a theoretical critique of the neo-classic monopoly theory and a defense of the classic view that monopolies can only exist if and insofar as free entry is restricted by legal compulsion, and that under conditions of free entry no operationally meaningful distinction between competitive vs. monopoly prices and/or output is possible, see Murray N. Rothbard, *Man, Economy, and State: A Treatise on Economic Principles* (Los Angeles: Nash Publishing, 1970), chap. 10; also Hans-Hermann Hoppe, *Eigentum, Anarchie und Staat. Studien zur Theorie des Kapitalismus* (Opladen, 1987), pp. 129–41; idem, *A Theory of Socialism and Capitalism*, chap. 9.

[19]See R. Merklein, *Griff in die eigene Tasche: Hintergeht der Bonner Sozialstaat seine Bürger?* (Hamburg, 1980); idem, *Die Deutschen werden ärmer. Staatsverschuldung, Geldentwertung, Markteinbussen, Arbeitsplatzverluste* (Hamburg, 1982).

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so-called labor-protection and anti-trust laws were drastically stiffened. Taxes and social security contributions were significantly increased, in order to finance all sorts of so-called public goods and enhance 'the quality of life.' By resorting to a Keynesian policy of deficit spending (the Federal government deficit rose from 57 billion deutsche marks in 1970 to 232 billion in 1980 and 503 billion in 1989), and aided by the fact that initially inflation was not anticipated, the economic consequences of these policies were delayed for a few years—only to appear later with a vengeance. Unanticipated inflation and credit expansion had created and prolonged the malinvestment typical of a boom; yet this boom, built on nothing but paper money, would inevitably be followed by a liquidation crisis—a recession.[20] Socialist chancellor Helmut Schmidt's motto had been "rather 5 percent inflation than 5 percent unemployment." In fact, not only was there soon much more than 5 percent inflation (inflation became anticipated and the demand for money declined), but unemployment also rose steadily, with both rates simultaneously approaching 10 percent. Economic growth slowed until early in the 1980s, when GNP fell in absolute terms. For the first time in West German history, the number of employed people actually decreased. More and more pressure was put on foreign workers to leave the country, and the immigration barriers were raised.

Since 1982, at which time the socialist-liberal government (and left-wing Keynesianism) was ousted and replaced by a conservative-liberal government coalition (and right-wing Keynesianism), West Germany has proceeded on its march toward the welfare state, if only at a slower pace: Government expenditures, which had increased from about 30 percent of GNP in 1960 to more than 50 percent in the early 1980s, and government debts have continued to rise. The inflation rate has been lowered, and the rate of economic growth raised. But neither rate has fallen or risen to levels anywhere near those which had characterized the Erhard era; and after 8 years of conservative-liberal rule the number of unemployed, which reached 2.3 million in 1983, was still above 2 million (nearly 8 percent). In this situation, the arrival of large numbers of East German immigrants at once eligible for West German welfare handouts and unemployment subsidies quickly began to expose not only the bankruptcy of socialism, but that of the West German welfare state as well.

[20]On the theory of the business cycle see Ludwig von Mises, "Monetary Stabilization and Cyclical Policy," in *On the Manipulation of Money and Credit*, Percy L. Greaves, ed. (1928; Dobbs Ferry, N.Y.: Free Market Books, 1978); Friedrich A. Hayek, *Prices and Production* (1931; London: Routledge & Sons, 1935); Richard von Strigl, *Kapital und Produktion* (Vienna, 1934); Murray N. Rothbard, *America's Great Depression* (Kansas City: Sheed & Ward, 1975).

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Thus, the threat of East Germany's political instability spilling over to West Germany forced the West German political power elite to act quickly and take the initiative in the inevitable process of reunification. However, contrary to the situation in the late 1940s, when Erhard had handled a similar crisis in German history by adopting an unpopular but successful strategy of free-market crisis management, some 40 years later the course pursued by West Germany's political establishment is yet another giant step toward welfare socialism and bound to further aggravate West Germany's economic stagnation (notwithstanding the popularity of the policy among the West and in particular the East German public). Rather than seeking German reunification through a quick and radical de-socialization of East Germany—and indirectly of West Germany—which alone would be in accordance with fundamental principles of justice and sound economics, and which will be outlined and explained shortly, West Germany's political power elite seeks the reunification through the complete incorporation of East Germany into the West German welfare state.

Immediately following the events of November 9, 1989, West Germany's political parties—the ruling conservative Christian Democratic Union, the liberal Free Democratic Party as its minor federal government partner, the Social Democratic Party as the major opposition party, and the national-conservative Republicans as well as the leftist Greens as the two minor opposition forces—largely in control of the West German state apparatus and essentially tax-funded (through campaign costs compensations), began to extend their presence to East Germany and establish sister organizations. In order to distract from their own steadily increasing invasion of private property rights, the East German crisis was labeled as one of non-democracy rather than non-private property.[21] The East German public,

[21]In fact the lack of democracy has essentially nothing to do with East Germany's plight. It is obviously not the selection principle for politicians that causes the problem. It is politics and political decision-making as such that are responsible. Collectively owned factors of production require collective decision-making. Instead of each producer deciding independently what to do with particular resources as under a regime of private property and contractualism, with socialized means of production each decision requires a collective's permission. It is irrelevant to the producer how those giving permission are chosen. What matters to him is that permission has to be sought at all. As long as this is the case, the incentive for producers to produce is reduced and impoverishment will continue. Privatization is as incompatible with democracy, then, as it is with any other form of political rule. Privatizing means to de-politicize society and to establish, in Marx's terms, an anarchy of production, in which no one rules anybody, and all producers' relations are voluntary and thus mutually beneficial.

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familiar with the West German political system via West German government television and overwhelmingly in favor of welfare-statist ideologies (the territory of East Germany had indeed traditionally been a stronghold of social-democratic and communist support), widely welcomed the West German party 'invasion.' East Germany's first multi-party election on March 18, 1990 ended with a resounding victory for the West German party system. The formerly ruling communist party, meanwhile reconstituted as the Party of Democratic Socialism, was ousted from power (while it remained the third largest party, with a remarkable 15 percent of the vote). Instead, the East German Christian Democratic Union-equivalent, boosted by its affiliation with West Germany's ruling party and its bribe-like promise of a 'generous' exchange rate for East marks through the West German central bank—most frequently proposed were rates of 1:1 or 2:1, which made the East mark rise immediately to 4:1 against the deutsche mark—and a quick and complete incorporation of East Germany into the Federal Republic via article 23 of the West German constitution (which provides for the possibility of legal entry, or *Anschluss*), became by far the strongest political force and senior partner in a newly formed conservative-liberal-social-democratic government coalition representing more than two thirds of the popular vote. Indirectly, the West German power elite had gained control of the development of East Germany and its future course of desocialization.[22]

The date for the official beginning of the German reunification process was set for July 2, 1990, and an outline of the reunification process, including a currency reform and the extension of the West German welfare system to East Germany as its key elements, was announced.[23]

East marks up to 4,000 per person would be exchanged at a rate

[22]The elections on October 14, 1990, in East Germany's reconstituted 5 federated states, and on December 2, 1990, in the meanwhile reunited Germany, confirmed these results and added even more strength to the ruling conservative-liberal government coalition. The national-conservative Republicans were reduced to insignificance; and the Green Party did not manage to return to the Federal Parliament (Bundestag). The PDS experienced further voter losses and, although currently represented in the Bundestag due to a provisionary suspension of the 5 percent hurdle for 'genuine' East German parties during the December election, it is bound ultimately to disappear as a political power.

Indicative of the West German power elite's political 'imperialism' is the fact that almost all of the three major parties' (CDU, FDP, and SPD) leading candidates in East Germany's October state election were 'imported' from West Germany.

[23]The formal reunification took place only three months later, on October 3, and was 'democratically ratified' in the first all-German election of December 2, 1990.

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of 1:1 against the deutsche mark (and at 2:1 in excess of this limit).[24] Because the East German money supply is only a small fraction of the deutsche mark supply, and because the market for non-money goods would automatically be expanded through the currency unification, the expected inflationary consequences will be relatively minor. However, the currency reform will cause a twofold income redistribution. On the one hand, it implies a compulsory redistribution of purchasing power from West German citizens onto East Germans, although the former are in no way responsible for the plight of the latter and indeed have in the past transferred massive amounts of income to East Germans on a voluntary basis. On the other hand, it implies a coercive income redistribution from West Germany's private sector onto the West German government—which will print the required deutsche marks essentially at no cost—and indirectly its East German government affiliate.

With this currency reform as its foundation, the socio-economic integration of East Germany would begin. Having supplied East Germany with 'sufficient' initial purchasing power, the East German government, directed by its Western senior partner, and as if it were the legitimate owner, would sell off state property.[25] East Germans would be given special treatment as buyers. The East German demand that West Germans be prevented for about a decade from buying land in East Germany has been defeated after a protracted battle, but other less severe restrictions are likely to remain in place. Further, among the hampered West German buyers, large established government-connected firms would enjoy a systematic advantage (in expectation of this likely event their stock market prices have already significantly increased). East Germans with valid titles to expropriated, socialized assets would be reinstated as private owners without having to pay, although only with a large number of exceptions favoring the current asset users over their original owners. On the other hand, West German holders of East German titles would be widely restricted from likewise reclaiming their property and receive instead some arbitrary sub-market price compensation.[26] Although

[24]For a detailed analysis of the currency reform see P. Bofinger, "The Germany Monetary Unification: Converting Marks to D-Marks," *Federal Reserve Bank of St. Louis Review* (July/August 1990).

[25]For this purpose a trust fund corporation (Treuhandanstalt) directed by West German establishment 'managers' was set up.

[26]In fact, the West and East German governments agreed in their reunification treaty of October 3, that all expropriations prior to the founding of the East German state in 1949 were to be regarded as "valid" (more than 50 percent of East Germany's

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substantial, the reprivatization of East Germany would not include any of the state's command posts—police, courts, traffic, communication, and education—and its extent will be significantly less than the degree of private ownership in West Germany so as to raise the relative size of the government sector for the united Germany above its current level in West Germany alone.[27]

Initially, the receipts from the sale of government assets would be used to finance East Germany's welfare system. Prominent among the already accepted provisions of this new system will be the complete adoption of West Germany's social security system: retirement benefits for East Germans, to be paid in deutsche marks, would be raised quickly to West German levels (at the pre-November 1989 market exchange rate of 5:1 they had been about 1/15 of those in the West). The current East German wages would be converted 1:1 into deutsche marks (which would lift them to about 1/2 of West German rates, and to roughly the same height as West Germany's average unemployment subsidies, as compared with a market value of about 1/10). In addition, East Germany would immediately introduce the West German unemployment 'insurance' system; and West Germany's highly centralized labor union organization and collective bargaining would take hold in East Germany. Further, rents would be converted 1:1; and at least 'temporarily', severe rent controls would remain in effect. All debts, denominated now in deutsche marks, would be cut in half. Lastly, but unsurprisingly already seen as of the highest priority, in order to finance current and future government expenditures the East German government would adopt West Germany's tax structure and, no longer in control of the money printing press, would immediately begin establishing an 'effective' decentralized tax collection system, assisted by its West German counterpart and the expertise of its *Finanzämter* (equivalent to the United States Internal Revenue System).

Naturally, the political power elite responsible for this reunification program has expressed little doubt about its success. Indeed, some of its representatives such as Chancellor Helmut Kohl and Otto Lambsdorff, head of West Germany's Free Democratic Party, have gone on record saying that it would "cost West Germany nothing." However, economic logic dictates otherwise and predicts rather dis-

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land used for agriculture had been forcibly socialized before this date). This provision is currently being challenged in the government's court system.

[27]After one year of de-socialization a mere 700 out of 9,000 East German 'production units' had been privatized.

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appointing results.[28]

To be sure, due to the partial re-privatization of East Germany and the lifting of most price controls, East Germany's economic performance would quickly improve over its present desperate showing. Yet the recovery process will not only be slower and much more painful than need be, it will soon be replaced by economic stagnation; and likewise, due to the relatively larger size of the government sector in the united Germany as compared to its present size in West Germany, stagnation tendencies will be strengthened within the already listless West German economy.

The full inclusion of East Germans into the West German social security system is bound to lead to increased social security taxes. Every restriction imposed on West German buyers of East German assets will also harm East Germans by not permitting them to sell to the highest bidder and will hamper the speedy transfer of assets into the most value-productive hands. Similarly, the preferential treatment accorded established West German companies will prevent the quickest breakup of the mostly oversized East German production units into efficient firms and contribute from the outset to the cartelization of East Germany's new economy. Rent controls will largely halt the reconstruction of East Germany's rental housing market from its shambled state and will lead to large-scale public housing projects (*sozialer Wohnungsbau*) and even higher taxes. However, worst of all for East Germany's economic recovery will be the combined policies of minimum wage guarantees and unemployment subsidies. For one thing, these policies will not stop the population outflow from East to the West with its higher wages and unemployment subsidies[29]; and with downwardly inflexible wage rates also in

[28]In fact, by early 1991, higher gasoline taxes, a 2.5 percent increase in the unemployment 'insurance' tax, and a 'temporary' 7.5 percent increase of the income tax had been introduced, and various other 'revenue enhancement' schemes had come under official consideration (including a road user fee, and a price increase for governmentally provided and monopolized telephone services). The money supply (M3) had been increased at an annual rate of 6 percent (as compared to 1 percent in the United States). Government debt *increases* rose from 20 billion deutsche marks in 1990 to an officially (under-)estimated 140 billion for 1991, to a total of some 900 billion, requiring nearly 10 percent of the Federal government's budget for interest payments (with an anticipated further increase to 17 percent by 1994). Due to increased government borrowing, the interest rate rose by about 1 percent (as compared to a 1 percent drop in the United States during the same period) and accordingly, private investment was 'crowded out.' In addition, some 10,000 new tenured government jobs (*Beamte*) had been 'created' in West Germany, so as to teach East Germany 'bureaucratic efficiency.'

[29]Since the currency unification and the incorporation of East by West Germany the number of emigrants has expectedly fallen (from above 2,000 per day). However, up to this day emigration from East to West continues at a rate of more than 500 per day.

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West Germany the continuing migration is bound to further aggravate West Germany's already recalcitrant unemployment problem. On the other hand, even at the present East mark-wage-rates the East German economy is largely uncompetitive in world markets. By actually fixing wage rates several times higher—by requiring nominally identical deutsche mark-wage-payments—the East German labor force will be priced out of the market to an even greater extent. The 'normal' flow of capital from high to low wage areas will be drastically reduced and massive—and with unemployment insurance—lasting unemployment will result. In order to finance East Germany's large-scale unemployment, steady massive transfer payments will be required from West to East, but also from East Germany's productive sector to its unproductive one. Once again, taxes and/or paper money creation will have to be substantially increased. Whatever new productive energies were set free by East Germany's partial privatization will immediately be stifled, and within an environment of rising unemployment figures and economic stagnation nationalistic sentiments, already on the rise, will receive another boost.[30]

While the course has largely been set and German reunification has proceeded through the incorporation of East Germany into the West German welfare state, an alternative existed which would have spared the Germans the economic frustrations inevitably associated with the current planned course of reunification.

Unfortunately, this radical alternative—the uncompromising privatization of East Germany, the adoption of a private-property constitution, and reunification through a policy of complete, unilateral free trade—has so far found practically no audience. Almost all alternatives proposed are variations of the same welfare-statist theme: either somewhat more drastic (i.e., more redistributionist), advocated mostly by Eastern economic 'experts', or somewhat more moderate, as advanced mostly by the economics establishment of West Germany. Nor does there appear to be any suspicion among the German public regarding this happy uniformity of expert opinion. Is it not curious that even in 'liberal' West Germany the instruments of opinion molding are largely in governmental hands? There are practically no private schools or universities; radio and television are

[30]By the end of 1990, the unemployment rate in East Germany had risen to about 25 percent (2.5 million); and increasing animosity among East Germans toward their own foreign 'guest workers' had become a widespread phenomenon.

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mostly state-owned or, in the case of a few exceptions allowed since the mid-1980s, subject to strict governmental licensing requirements; and there are almost no independent, private free-market think-tanks or foundations. Moreover, why should the West German power elite and the economic establishment on its payroll actually have the same interests as the German public? Indeed, is it not much more realistic to assume, as the Austrian school of economics long ago explained[31] and the public choice school has reiterated more recently,[32] that government officials and their intellectual bodyguards, like everyone else, pursue their own narrow self-interest rather than promoting the so-called public good? And is it not rather obvious that the interest of the West German government and its Eastern affiliate is the expansion of its own power: of tax revenue and governmentally controlled assets. The presently unfolding reunification process promotes precisely *this* goal and is indeed bound to lead to Germany's becoming Europe's foremost political power: and that what might appear as an ill-conceived strategy from the point of view of the German public, then, is actually the successful accomplishment of the German government's own different, even antagonistic interests?[33]

The German public today is too authoritarian minded to ask any such questions seriously. Much learning the hard way will be required, and much damage done, before the radical privatization alternative is to receive its chance, if ever it does. Only then may the German public begin to realize that the complete neglect of this option among the presently discussed reunification strategies may not be an accident, but have a systematic explanation.

The solution of the present crisis must begin with the recognition that while it may not be the East Germans' fault that they are as bad off as they are, it is also not the fault of the West Germans. As a matter of fact, the millions of people who left East Germany for the West, in many cases risking their lives, actively contributed to the undermining of the East German regime and in any case demonstrated *correct*

[31]See Ludwig von Mises, *Bureaucracy* (New Haven: Yale University Press, 1944).

[32]See James M. Buchanan, *What Should Economists Do?* (Indianapolis, Ind.: Liberty Fund, 1979); Gordon Tullock, *The Politics of Bureaucracy* (Washington, D.C.: Public Affairs Press, 1965).

[33]On the theory of the state see Franz Oppenheimer (one of Ludwig Erhard's teachers), *System der Soziologie, Vol. 2: Der Staat* (Stuttgart, 1964); Albert J. Nock, *Our Enemy the State* (Delevan: Hallberg Publishing, 1983); Murray N. Rothbard, *For A New Liberty*, (New York: Macmillan, 1978); idem, *The Ethics of Liberty* (Atlantic Highlands: Humanities Press, 1982); Hans-Hermann Hoppe, *Eigentum, Anarchie und Staat*; idem, *A Theory of Socialism and Capitalism*; Anthony de Jasay, *The State* (Oxford: Blackwell, 1985).

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entrepreneurial judgment, whereas millions of East Germans collaborated with the regime—socialist party membership was above 2 million, or some 15 percent of the population, and many more willingly participated by looting the property left behind by emigrants. Even those who did not do so obviously displayed *poor* entrepreneurial foresight. To compel the West German populace to give wholesale financial support to East Germans, then, not only constitutes a moral outrage, but is a counterproductive measure as well. Justice and economics require instead that East Germany solve its problems alone, without anything but voluntary West German assistance. Accordingly, any form of compulsory redistribution should be rejected outright. There should be no currency reform of the sort already inaugurated, but exchange at market rates[34]; and likewise, there should be no incorporation, but a decidedly *separatist* reunification course chosen.

Since the ultimate cause of East Germany's economic misery is the collective ownership of factors of production, the solution and key to a prosperous future is privatization. Yet how can socialized property be privatized justly?[35] There is a second moral observation at the beginning of the answer to this question. The former East German government was, and is by now largely recognized by the East German population as a criminal organization, guilty of murder, robbery and, in erecting an impenetrable wall around the country responsible for the enslavement of an entire people. Not only should those directly responsible for these activities be prosecuted far beyond the current timid attempts in this direction, but all government property, ill-begotten from the very start, should be forfeited. The new government, even if freely elected, cannot be considered the owner of any property, for a criminal's heir, even if himself innocent of any crimes, does not become the legitimate owner of illegitimately acquired assets. On account of his personal innocence he remains exempt from prosecution; but all of his 'inherited' gains must imme-

[34]Temporarily—until the East Germans were willing to adopt a still better *commodity* money such as gold, for instance—this would lead to the rapid replacement of the *bad* East mark by the *good* deutsche mark, to deflationary pressure put on deutsche mark prices, and to the welcome lowering of East German import prices.

[35]While a vast body of literature dealing with the socialization of private property exists, hardly anything has been written on how to de-socialize. Most likely, one would suspect, because of most Western intellectuals' explicit or implicit socialist predilections, which preclude any treatment of this problem as simply irrelevant. For why should anyone ever want to go back from an allegedly *higher stage of social evolution*, i.e., socialism, to a lower one, i.e., capitalism? As one of the few exceptions see Murray N. Rothbard, "How To Desocialize?," *Free Market*, vol. 7 (Auburn, Ala.: The Ludwig von Mises Institute, September 1989).

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diately revert to the original victims, and their repossession of government property must take place without their being required to pay anything. In fact, to charge a victimized population a price for the reacquisition of what was originally its own would itself be a crime and once and forever take away any innocence the new East German government previously might have had.

More specifically, all original property titles should be immediately recognized, regardless of whether they are presently held by East or West Germans. Insofar as the claims of original private owners or their heirs clash with those of the current asset users, the former should in principle override the latter. Only if a current user can prove that an original owner-heir's claim is illegitimate, i.e., that the title to the property in question had been acquired initially by coercive or fraudulent means, should a user's claim prevail and should he be recognized as owner.[36] In the case of East Germany—in contrast to that of the Soviet Union, for instance,—where the policy of expropriation started only some 40 years ago, where most land registers have been preserved, and where the practice of government authorized murder of private-property owners was relatively 'moderate', this measure would quickly result in the reprivatization of most, though by no means all, of East Germany. Regarding governmentally controlled resources that are not reclaimed in this way, syndicalist ideas should be implemented. Assets should become owned immediately by those who use them—the farmland by the farmers, the factories by the workers, the streets by the street workers, the schools by the teachers, the bureaus by the bureaucrats (insofar as they are not subject to criminal prosecution), and so on.[37] To break up the mostly over-sized East German production conglomerates, the syndicalist principle should be applied to those production units in which a given individual's work is actually performed, i.e., to individual office buildings, schools, streets or blocks of streets, factories and farms. Unlike syndicalism, yet of the utmost importance, the so acquired individual property shares should be freely tradeable and a stock market established, so as to allow a separation

[36]In those cases in which current users actually bought expropriated assets from the government, they should seek compensation from those responsible for this sale of loot, and the government officials accountable for it should be compelled to repay the purchase price, if necessary through forced labor.

[37]On the economics and ethics of privatization see Murray N. Rothbard, *For A New Liberty*; for the privatization of streets in particular Walter Block, "Free Market Transportation: Denationalizing the Roads," *Journal of Libertarian Studies* (1979); idem, "Public Goods and Externalities: The Case of Roads," *Journal of Libertarian Studies* (1983).

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of the functions of owner-capitalists and non-owning employees, and the smooth and continuous transfer of assets from less into more value-productive hands.[38]

Two problems are connected with this privatization strategy. For one thing, what is to be done in the case of newly erected structures—which according to the proposed scheme would be owned by their current productive users—built on land that is to revert to a different original owner? While it may appear straightforward enough to award each current producer with an equal property share, how many shares should go to the land owner? Structures and land cannot be physically separated. In terms of economic theory, they are absolutely specific complementary production factors whose relative contribution to their joint value product cannot be disentangled. In these cases there is no alternative but to bargain.[39] Yet this—contrary to the first impression that it might lead to permanent, unresolvable conflict—should hardly cause many headaches. For invariably there are only two parties and strictly limited resources involved in any such dispute. Moreover, to find a quick, mutually agreeable compromise is in both parties' interest, and if either party possesses a weaker bargaining position it is clearly the landowner (because he cannot sell the land without the structure owners' consent while they could dismantle the structure without needing the landowner's permission).

Secondly, the syndicalist privatization strategy implies that producers in capital intensive industries would have a relative advantage as compared to those in labor intensive industries. For the value of the property shares received by the former would exceed the wealth awarded to the latter, and this unequal distribution of wealth would require justification, or so it seems. In fact, such justification is readily available. Contrary to widespread 'liberal' myths, there is nothing ethically wrong with inequality.[40] Indeed, the problem of privatizing formerly socialized property is almost perfectly analogous to that of establishing private property in a *state of nature*, i.e., when resources previously had been unowned. In this situation, according

[38]For an economic analysis of syndicalism see Ludwig von Mises, *Socialism*, chap. 16, sec. 4.

[39]On the economic theory of bargaining see Ludwig von Mises, *Human Action*, pp. 338-39; and Murray Rothbard, *Man, Economy, and State*, pp. 308-12.

[40]See Murray N. Rothbard, *Egalitarianism As A Revolt Against Nature and other Essays*, (Washington, D.C.: Libertarian Review Press, 1974); also: Robert Nozick, *Anarchy, State, and Utopia* (New York: Basic Books, 1974), chap. 8; Helmut Schoeck, *Der Neid. Eine Theorie der Gesellschaft* (Munich, 1966); idem, *Das Recht auf Ungleichheit* (Munich, 1979); Erik von Kuehnelt-Leddhin, *Freiheit oder Gleichheit* (Salzburg, 1953).

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to the central Lockean idea of natural rights which coincides with most people's natural sense of justice, private property is established through acts of homesteading: by mixing one's labor with nature-given resources before anyone else has done so[41]; and insofar as any differences between the quality of nature-given resources exist, as is surely the case, the outcome generated by the homesteading ethic is inequality rather than equality.[42] The syndicalist privatization approach is merely the application of this homesteading principle to slightly changed circumstances. The socialized factors of production are already homesteaded by particular individuals. Only their property right regarding particular production factors has so far been ignored, and all that would occur under the proposed scheme is that this unjustifiable situation would finally be rectified. If such rectification results in inequalities, this is no more unfair than the inequalities that would emerge under a regime of original, unadulterated homesteading.[43]

Moreover, our syndicalist proposal is economically more efficient than the only conceivable privatization alternative in line with the basic requirement of justice (that the government does not legitimately own the socialized economy and hence its selling or auctioning it off should be out of the question). According to the latter alternative, the entire population would receive equal shares in all of the country's assets not reclaimed by an original, expropriated owner. Aside from the questionable moral quality of this policy,[44] it would be

[41]See John Locke, *Two Treatises of Government*, Peter Laslett, ed. (Cambridge: Cambridge University Press, 1960), pp. 305-07.

[42]For an attempt to justify an *egalitarian* homesteading ethic see H. Steiner, "The Natural Right to the Means of Production," *Philosophical Quarterly* 27 (1977); for a refutation of this theory as inconsistent see Jeffrey Paul, "Historical Entitlement and the Right to Natural Resources," in Walter Block and Llewellyn H. Rockwell, eds., *Man, Economy, and Liberty: Essays in Honor of Murray N. Rothbard* (Auburn, Ala.: The Ludwig von Mises Institute, 1988); Fred D. Miller, "The Natural Right to Private Property," in Tibor R. Machan, ed., *The Libertarian Reader* (Totowa: Rowman & Littlefield, 1982).

[43]For the most consistent and complete Lockean property rights theory see Murray Rothbard, *The Ethics of Liberty*; idem, "Law, Property Rights, and Air Pollution," *Cato Journal* 2, no. 1 (Spring 1982); for a theoretical justification of the homesteading principle in particular, as the indisputable, axiomatic foundation of ethics see Hans-Hermann Hoppe, *Eigentum, Anarchie und Staat*, chap. 4; idem, *A Theory of Socialism and Capitalism*, chaps. 2 and 7; idem, "From the Economics of Laissez Faire to the Ethics of Libertarianism," in Walter Block and Llewellyn H. Rockwell, eds., *Man, Economy, and Liberty*; idem, "The Justice of Economic Efficiency," *Austrian Economics Newsletter* 9, no. 2 (Winter 1988).

[44]How can one justify that ownership of productive assets should be assigned without considering a given individual's actions or inactions in relation to the owned asset? More specifically, how can it be justified, for instance, that someone who has contributed literally nothing to the existence or maintenance of a particular asset—and

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extremely inefficient. For one thing, in order for such countrywide distributed shares to become tradeable property titles, they must specify to which particular resource they refer. Hence, to implement this proposal, first a complete inventory of all of the country's assets would be required, or at least an inventory of all its distinctively separable production units. Secondly, even if such an inventory were finally assembled, the owners would consist by and large of individuals who knew next to nothing about the assets they owned. In contrast, under the non-egalitarian syndicalist privatization scheme no inventory is necessary. Furthermore, initial ownership comes to rest exclusively with individuals who, because of their productive involvement with the assets owned by them, are by and large best informed to make a first realistic appraisal of such assets.

In conjunction with the privatization of all of East Germany according to the principles outlined, the current East German government should adopt a private property constitution and declare it the immutable basic law for the entire East German territory. This constitution should be extremely brief and lay down the following principles in terms as unambiguous as possible: Every person, apart from being the sole owner of his physical body, has the right to employ his private property in any way he sees fit so long as in so doing he does not uninvitedly change the physical integrity of another person's body or property. All interpersonal exchanges and all exchanges of property titles between private owners are to be voluntary (contractual). These rights of a person are absolute. Any person's infringement on them is subject to lawful prosecution by the victim of this infringement or his agent, and is actionable in accordance with the principles of the proportionality of punishment and of strict liability.[45]

As implied by this constitution, then, all existing wage and price controls, all property regulations and licensing requirements, and all import and export restrictions should be immediately abolished and complete freedom of contract, occupation, trade and migration introduced. Subsequently, the East German government, now property-

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who might not even know that any such asset exists—should own it in the same way as someone else who actively, objectifiably contributed to its existence or maintenance?

[45]On the proportionality principle of punishment see Murray Rothbard, *The Ethics of Liberty*, chap. 13; Hans-Hermann Hoppe, *Eigentum, Anarchie und Staat*, pp. 106-28; on the principle of strict liability also Richard A. Epstein, "A Theory of Strict Liability," *Journal of Legal Studies* 2 (January 1973); idem, "Medical Malpractice: The Case for Contract," *Center for Libertarian Studies: Occasional Paper Series*, no.9 (Burlingame, 1979); Judith J. Thomson, *Rights, Restitution, and Risk* (Cambridge: Harvard University Press, 1986), esp. chaps. 12 ("Remarks on Causation and Liability") and 13 ("Liability and Individualized Evidence").

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less, should declare its own continued existence unconstitutional—insofar as it would have to rest on non-contractual property acquisitions, that is, taxation—and abdicate.[46]

The result of this complete abolition of socialism and the establishment of a pure private-property society—an anarchy of private-property owners, regulated exclusively by private-property law—would be the quickest economic recovery of East Germany. From the outset, East Germany's population would, by and large, be made amazingly rich. For while the East German economy is in shambles, the country is not destroyed. High real-estate values exist, and in spite of all capital consumption of the past there are still massive amounts of capital goods in East Germany. With no government sector left and the entire national wealth in private hands, East Germans could soon become the envied objects of their West German counterparts.[47]

Moreover, with factors of production released from political control and handed over to private individuals who are allowed to use them as they see fit—independent of whatever anyone else may want—provided only that they do not physically damage the resources owned by others, the ultimate stimulus for future production is provided. With an unrestricted market for capital goods, rational cost-accounting is made possible. With profits as well as losses individualized, and reflected in an owner's capital- and sales-account, every single producer's incentive to increase the quantity and/or quality of his output and to avoid any over- or underutilization of his capital is maximized. In particular, the constitutional provision that only the physical integrity of property (not property values) be protected guarantees that every owner will undertake the greatest value-productive efforts—efforts to promote favorable changes in property values and to prevent and counter any unfavorable ones (as might result from another person's actions regarding his property).

Specifically, the abolishment of all price controls would almost instantaneously eliminate all present shortages; and output would immediately begin to increase, quantitatively as well as qualitatively.

[46]On the ethics and economics of state-less societies see Murray N. Rothbard, "Society Without a State," in J. Roland Pennock and John W. Chapman, eds., *Anarchism (Nomos 19)* (New York: New York University Press, 1978); Bruce Benson, *The Law, The Legal System and The State* (San Francisco: Pacific Institute, 1991).

[47]National wealth statistics are notoriously problematic. However, for illustrative purposes it might be worthwhile to point out that estimates of East Germany's national wealth range from 30 to 800 trillion deutsche marks. Using the lowest estimate and adding to the East German population some 4 million West Germans reclaiming their Eastern property this would amount to per capita assets of about $900,000.

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Temporarily, unemployment would drastically increase, as it did in West Germany after World War II. Yet with flexible wage rates, no collective bargaining, and no unemployment subsidies it would quickly begin to disappear again. Initially, average wage rates would remain substantially below West German rates. But this, too, would soon begin to change. Lured by comparatively low wages, by the fact that East Germans will expectedly show a great need for cashing in (liquidating) their newly acquired capital assets so as to finance their current consumption, and above all by the fact that East Germany would be a no-tax, free-trade haven, large numbers of investors and huge amounts of capital, in particular from wealthy neighboring West Germany, would immediately begin to flow in.

The production of security—of police protection and of a judicial system—which is usually (without argument) assumed to lie outside the province of free markets and be the proper function of government, would most likely be taken over by the major West German insurance companies.[48] Providing insurance for personal property, police-action—the prevention and detection of crime as well as the exaction of compensation—is in fact part of this industry's natural business (if it were not for governments preventing it from doing so and arrogating this task to itself, with all the usual and familiar inefficiencies resulting from such a monopolization). Likewise, being already in the business of arbitrating conflicts between claimants of competing insurers, they would naturally assume the function of a judicial system.[49]

Yet more important than the entrance of big business, such as insurance companies in the field of security production, would be the influx of large numbers of small entrepreneurs from West Germany. Facing not only a heavy load of taxation in the West but being stifled

[48]On the economics of competitive, private security production see Gustave de Molinari, "The Production of Security," *Center for Libertarian Studies: Occasional Paper Series*, no. 2 (Burlingame, Calif., 1977); Murray Rothbard, *Power and Market*, chap. 1; idem, *For A New Liberty*, chap. 12; Morris and Linda Tannehill, *The Market For Liberty* (New York: Laissez Faire Books, 1984); W. Wooldridge, *Uncle Sam the Monopoly Man* (New Rochelle: Arlington House, 1970); Bruno Leoni, *Freedom and the Law* (Princeton: Van Nostrand, 1972); Hans-Hermann Hoppe, "Fallacies of the Public Goods Theory and the Production of Security," *Journal of Libertarian Studies* 9, no. 1 (1989); Bruce Benson, *The Law, The Legal System and The State*.

[49]As regards national defense one should note that for the foreseeable future, this is not a problem for East Germany. West Germany would certainly not attack East Germany—public opinion would make this impossible. And insofar as the Soviet Union is concerned, it will continue to station troops on East German territory for the time being under *any* scenario. On the privatization of defense see Murray Rothbard, *For A New Liberty*, chap. 13; also, Jeffrey Rogers Hummel, "National Goods vs. Public Goods: Defense, Disarmament, and Free Riders," *Review of Austrian Economics* 4 (1990).

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there by countless regulations (licensing requirements, labor protection laws, mandated working and shop-opening hours), an unregulated East German private-property economy would present an almost irresistible attraction. The large-scale import of entrepreneurial talent and capital would soon begin to raise real wage rates in East Germany, stimulate internal savings, and lead to a rapidly accelerating process of capital accumulation. Rather than people leaving the East, migration would quickly take place in the opposite direction, with increasing numbers of West Germans abandoning welfare socialism for the unlimited opportunities offered in the East. Finally, faced with increasing losses of productive individuals, which would put even more pressure on West Germany's welfare budgets, the West German power elite would be forced to do what it presently is trying desperately to avoid with its own strategy of reunification through incorporation: to begin to de-socialize West Germany as well.

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Notes and Replies

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The Preferred Tax Type: Comment on Herbener

Alexander Tabarrok*

A standard theorem in neoclassical public finance holds that income taxes are preferred to equal revenue excise taxes.[1] Herbener (1988) rejects this theorem because the proof is (a) based upon methodologically suspect indifference curves and (b) must follow a certain conceptual ordering—namely the excise tax must first be placed upon consumers who are then given the option of facing an equal-revenue income tax and not vice versa. This comment demonstrates that indifference curves are not required to prove the theorem nor must the proof of the theorem follow a specific order.

It is an easy job to prove the theorem without using indifference curves, as has been done many times.[2] The proof requires only the idea of revealed (or demonstrated) preference. Consider figure 1: there are two goods, money (M) and a good X; AA represents the initial budget line, AC is the new budget line after an excise tax has been placed on good X.[3] Let us say that the consumer chooses the consumption bundle at point D which is on his budget constraint AC.[4] The budget constraint when an equal revenue income tax is imposed must pass through point D and is labelled BB. The consumer now has the option of staying at D (his most preferred position under the excise tax) or consuming anywhere along BB. If the consumer switches, this demonstrates his utility has increased and proves the theorem. We now show that the consumer will switch.

Consider line segment BD. The consumer had enough income to

*Alexander Tabarrok is a graduate student in economics at George Mason University.

[1]See Herbener's note 8 for numerous references to different versions of this theorem.

[2]In fact, the originator of indifference curves and one of the earliest economists to prove the theorem, J. R. Hicks (1946, p. 41), uses a revealed preference approach.

[3]We are following the traditional ordering for this part of the proof. See below.

[4]The proof does not depend on where point D is so long as it is on the budget constraint AC. This is guaranteed by the praxeological law that more of a good is preferred to less.

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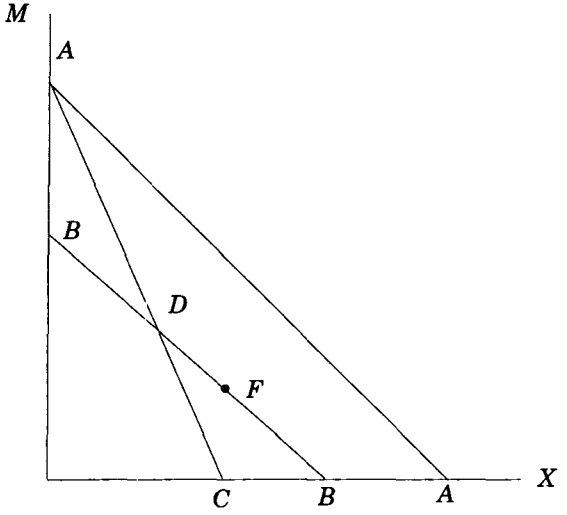

Figure 1.

consume anywhere along *BD before* the income tax was introduced. In fact, the consumption bundles along line segment *AD* contain more of both types of goods than those along *BD* and the consumer could have chosen any of these bundles. By choosing not to consume along *AD* the consumer has demonstrated that he prefers bundle *D* to any other point along line segment *AD* and a *fortiori* line segment *BD*. Now compare line segment *DB* with *DC*. More of both types of goods are available to the consumer along line segment *DB* than *DC*. Since more of a good is preferred to less we can state with assurance that the consumer will choose to change his consumption from *D* to a point somewhere along *DB* such as *F*.[5] The fact that the consumer voluntarily changes his consumption bundle demonstrates that his utility increases.

It has now been shown that following the traditional sequence the preferred tax theorem can be proven without the concept of indifference. We have needed only the idea of revealed/demonstrated preference and the law that more is preferred to less.[6]

[5]It is possible for the consumer to continue to prefer *D* to any other point along *DB* but this requires *X* to be a non-good at point *D*.

[6]Rothbard (1956) has criticized Samuelson's (1948) concept of revealed preference because it assumes constancy of tastes through time. However, his critique was made in the context of Samuelson's attempt to map out the "preference function." No such attempt has been made here. The only constancy that is assumed is that the assumptions with which the analysis begins—in particular that money and *X* are both goods—remain true at the end of the analysis. This sort of constancy is required by any deductive theory.

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Herbener's second critique of the preferred tax theorem is that the proof requires a certain sequence of events: (1) the excise tax is placed on good *X*, (2) the amount of tax revenue is measured, (3) an equal-revenue income tax is levied. He argues that the sequence cannot begin with an income tax followed by an equal-revenue excise tax because the government does not know the preferences of individuals and therefore cannot compute the equal-revenue excise tax. According to Herbener the first scheme is the one that is presented "because only it allows the government to conduct the postulated experiment." But as Herbener himself notes, the neoclassical method (at least the part required to prove the theorem) is axiomatic and deductive. The theorem is a conclusion of theory and not a description of how to conduct an experiment.[7]

For a theory to be correct it need not be experimentally testable. But it must have true premises and sound reasoning. The preferred tax theory is presented the way it is because this is the only method which guarantees that one of the implied premises is true. The implied premise which must be true for the theory to hold is that there exists an excise tax capable of generating revenue equal to that of an income tax. The sequence of the first proof guarantees that this premise is true because the excise tax is placed first followed by an equal-revenue income tax.[8] The alternate sequence, proposed by Herbener, cannot guarantee that this statement is true. No excise tax on toothpicks could raise the same amount of revenue as does the present income tax of the United States. This is the problem which the first sequence avoids.

If we make the implied premise explicit, then the proof follows as before. Referring to figure 1, *AA* is the original budget constraint, *BB* is the budget constraint after an income tax. Let us assume, so as not to clutter the diagram, that the consumer chooses bundle *F*. We now assume that an excise tax exists which raises revenue equal to that of the income tax. In general we do not know exactly how high this tax must be but this is irrelevant as far as the theory is concerned.[9] We do know by assumption that such a tax exists; assume that it is *AC*. If *AC* is the equal revenue excise tax then we know that the

[7]There is no reason it could not be both, but this is unimportant for present purposes.

[8]As a matter of logic, *ceterius paribus*, it must be true that an income tax can always raise as much money as an excise tax.

[9]The situation is equivalent to knowing that demand curves slope downward yet being unable to *a priori* predict by how much quantity demand increases when price falls by 10 percent.

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consumer must be consuming at point D (any other point along AC would raise to much or to little revenue). But point D was available to our consumer before the excise tax was imposed and he chose not to consume at that point. His action demonstrated that he preferred to consume at point F. We therefore know that this consumer's utility has been unambiguously decreased by the switch from an income tax to an excise tax.

Concluding Comments

It has been shown without the use of indifference curves and using either sequence that an income tax is preferred to an equal-revenue excise tax. As Herbener notes, and is widely recognized, this type of analysis is only partial in nature. Taxes also have effects on the production side of the economy.

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Comment on Preferred Tax Type: Reply to Tabarrok

Jeffrey M. Herbener*

I appreciate the opportunity to respond to the criticisms made by Alexander Tabarrok of my preferred-tax-type article since it provides a forum to clarify and elaborate on what is wrong with this neoclassical "theorem," as he calls it.

Before addressing the critique, I would like to make two historical clarifications. J. R. Hicks did not originate indifference curves as my critic claims (p. 107n). That "honor" goes to Francis Edgeworth, who gave a complete mathematical description of this technique in his *Mathematical Psychics*, published in 1881.[1] Vilfredo Pareto's extensive development and use of indifference-curve analysis also predates the work of Hicks in this area.[2] Hicks even gives credit to these two authors at various places in his *Value and Capital*.[3]

Second, I expended considerable effort at the beginning of the original article to establish the fact that I am an unabashed Misesian economist, and thus my major complaint against the neoclassical economists approach to the preferred-tax-type question is their failure to correctly employ the axiomatic-deductive method. Tabarrok seems to imply that my point about the government's inability to conduct the postulated experiment concerning equal tax revenues concerns the empirical problem of the testability of an hypothesis. But I wholeheartedly agree with him when he states, "For a theory to be correct it need not be experimentally testable. But it must have true premises and sound reasoning" (p. 109). The major argument of

*Jeffrey M. Herbener is assistant professor of economics at Washington and Jefferson College.

[1]See F. Y. Edgeworth, *Mathematical Psychics* (New York: Augustus M. Kelly Publishers, 1967 [1881]), pp. 35–36.

[2]See V. Pareto, *Manual of Political Economy* (New York: Augustus M. Kelley Publishers, 1971 [1909]), pp. 118f.

[3]See J. R. Hicks, *Value and Capital*, 2nd ed. (Oxford: Oxford University Press, 1946 [1939]), pp. 13 and 41f.

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my original article was precisely that the neoclassical theory had false premises and unsound reasoning and was therefore false. The problem of conducting the experiment that I referred to was the *mental* experiment necessary to the praxeological method.[4]

Tabarrok makes two criticisms of my original article: indifference curves are not required to prove the "theorem" and the proof does not depend on a specific sequence. By dropping indifference curves, Tabarrok has dramatically changed the conditions of the analysis and thus, his criticisms do not affect my original results, derived assuming a well-behaved set of indifference curves. This is not much consolation, however, if his assertion is true that indifference curves are not necessary for the proof. Let me demonstrate the difficulty of proving the "theorem" without them, or at least some additional restrictions on preferences beyond Tabarrok's "more is preferred to less" assumption.[5]

Consider figure 1, a reproduction of Tabarrok's figure 1. The individual begins by choosing point A with no taxation. Now the government imposes an excise tax on good X, *at some fixed rate per unit* (they do not fix the amount of the tax revenue, the individual's choice determines his tax payment), causing the budget constraint to rotate inward to M_0X_E. The individual chooses point B with an amount of tax extracted of M_0M_1. Now he is offered another opportunity; pay the same amount of tax and choose any combination along M_1X_1. Given the expanded range of choice, he can assuredly find a preferable point, say C. But note carefully, he prefers C to B because, by assumption, it is his most preferred point on his entire income tax budget line. From a tax-payment standpoint, when he compares C to a point along M_0X_E, say D, he prefers it *because it involves a lower* tax payment. It has nothing to do with comparing equal tax revenues extracted in two different forms. By construction, his choice is between a fixed income tax payment and a fixed excise tax rate. With the latter, point B is the only point on M_0X_E that extracts the same amount of tax, M_0M_1, as the income tax. With the excise tax option,

[4]Ludwig von Mises calls such mental experiments imaginary constructions, Mises, *Human Action*, 3rd rev. ed. (New Haven: Yale University Press, 1966 [1949]), pp. 31–32, 64–69, and 236–237.

[5]There are two praxeological laws of utility: the law of diminishing marginal utility and the law of increasing total utility. The first states that with units of a given size the marginal utility of each unit declines as the stock of the good increases. The second states that the marginal utility of a larger-sized unit exceeds the marginal utility of a smaller-sized unit. Both laws derive from the same source, viz., the purposefulness of human action, and thus in praxeological analysis one cannot "assume" the latter without "assuming" the former. See Murray N. Rothbard, *Man, Economy, and State* (Los Angeles: Nash, 1962), pp. 17–28 and 270.

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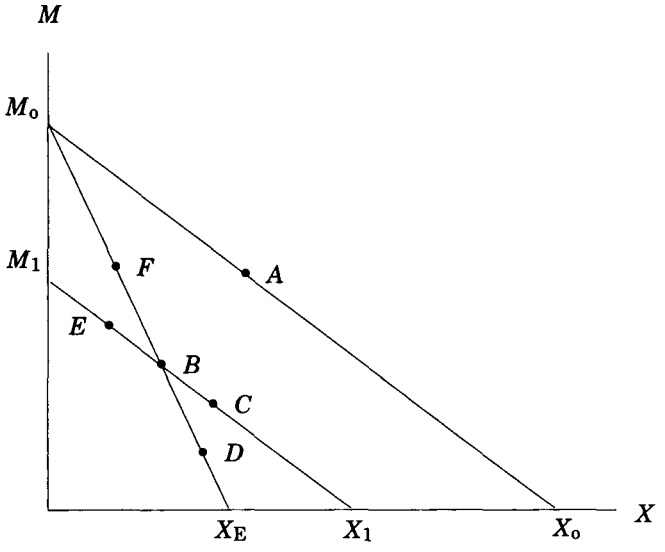

Figure 1.

the individual must stay at point B, *in order to pay the same tax*, while the income tax option he can select from various combinations of M and X. The individual's choice of the income tax is not based on his preference concerning tax types but on the fact that the analysis allows him no effective choice with the excise tax option.

Let me make this point from a different angle. What if his most preferred point on M_1X_1 was point E? With indifference curves this would be impossible but without them, or some added restriction beyond more is preferred to less, this can not be ruled out.[6] Then what he would prefer to do is move to some point on M_0B to the left of point B. He may prefer point B to any other point on M_0X_E, but he prefers, say, point F, to point E *because it involves a lower tax payment*. The

[6]It is insufficient to respond to this choice by arguing that it violates the law of demand. Indifference curves are the underpinnings of the neoclassical conception of the law of demand and the latter cannot be assumed to exist without them, in the neoclassical paradigm, without restrictions on preferences beyond more is preferred to less (see note 5). Also, the law of demand can only be derived *ceteris paribus*. Point B is selected under different underlying conditions than point E and thus, cannot be ruled out by the assumption that more is preferred to less. If this still seems untenable then consider the alternative sequence of tax offerings. Say an income tax is offered first and the individual selects point E, establishing it as his most preferred point on M_1X_1. Now he is given the excise tax option at a rate resulting in M_0X_E along which he prefers point B. The same situation is created.

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analysis only allows the comparison of a fixed excise tax rate with a fixed income tax payment.[7] Equalizing tax payments forces the individual to consider only one combination of M and X with the excise tax against many such combinations with the income tax.

Only one way exists to make the two tax types render the same tax payment (while not eliminating the individual's choice under the excise tax): allow the individual to freely select the excise tax rate. (The original excise tax rate is arbitrary and no specific rate is necessary to extract a given sum of tax revenue; it depends on the individual's choice.) Otherwise, one is comparing a fixed excise tax rate with a fixed income tax payment, which, as I stated in the original article, is not the postulated question.[8] If the individual picks the excise tax rate, without indifference curves to bind him, he will pick the rate so that the excise tax budget line will go through point C, allowing him to continue to consume his most preferred combination on M_1X_1. (With indifference curves this is impossible since they cannot intersect). Such a rate is the only one that allows the question of comparing the two tax types to be answered. And the answer is: He will be, dare I say it, indifferent between the two tax types.[9] This result stems from posing the correct question: The government will take M_0M_1 in income from you regardless of the collection method; which do you prefer? Without indifference curves to obscure the analysis, this question can finally be meaningfully asked, but the result is to reveal the two tax types as a lump-sum tax from the individual's perspective collected in two different ways (we are ignoring the other diverse effects of the two taxes). As I mentioned in the original article, the individual cares much more about how much he is forced to pay than in what manner the tax is collected.[10]

Tabarrok's quip about an excise tax on toothpicks not being a source of tax revenue equivalent to an income tax is erroneous (p. 109). As long as the individual continues to purchase at least one toothpick the government could indeed raise an equal amount of tax revenue by applying a very high excise tax rate. And why should it matter to

[7]Unless the government forces the individual to buy the amount of X at point B. I made this point in the original article; see Herbener, "Austrian Methodology: The Preferred Tax Type," *Review of Austrian Economics* 2 (1988): 106. It is this additional coercion that makes the excise tax option less preferable.

[8]See Herbener, "Austrian Methodology," p. 106.

[9]His indifference in this situation is an artificial construct of the analysis, not a conceivable demonstrated preference. Only his action, i.e., his choice, can reveal which he actually prefers. The point in this analysis is that nothing definitive can be said about this choice, e.g., he *must* prefer one to the other.

[10]See Herbener, "Austrian Methodology," p. 105.

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the individual if the government forces him to pay $5000 in income tax by sending a check payable to the IRS or $5000 in excise tax by sending a check to Tom's Toothpick Outlet which Tom sends on to the IRS? This is the only plausible meaning of the phrase "equal tax revenue," i.e., the only way in which the government can conduct the postulated (mental) experiment.

But this result is not what an individual unbound from indifference curves will accept under the sequence of excise tax then income tax options. Without indifference curves, the individual would do the following (remember, he prefers point A to all others): Offered the excise tax option at the fixed rate, he would choose point M_0, i.e., he would consume no X (zero tax payment); then, offered an income tax of the same amount, he would move back to point A, paying nothing in taxes. This result does not require shifting preference rankings. His rankings would be: (1) point A with no tax, (2) point M_0 with the threat of excise tax, (3) point C forced to pay the tax of M_0M_1, (4) point B forced to pay the tax of M_0M_1 and forced to buy the amount of X at point B. Indifference curves prevent this subjective maneuvering, making it appear that the analysis is answering the posited question.

For further clarification, let us explore the alternative sequence. Without indifference curves and forced to pay the income tax of M_0M_1, the individual selects point C, which, by construction, must be his most preferred combination on M_1X_1. Now he is offered the excise tax option that renders the same tax payment, but not a given excise tax rate, and asked to choose. Because point C is his most preferred combination, he will continue to choose point C, not some point to the left of C as Tabarrok contends, asking for an excise tax rate such that the budget line runs from point M_0 through point C. (Otherwise the analysis is comparing a fixed income tax payment with a fixed excise tax rate.) Again he is indifferent between the two tax types. This result is impossible with indifference curves since the indifference curve tangent to the excise-tax budget line at point C would intersect the one tangent to the income-tax budget line at point C. The use of indifference curves obscures the analysis, making it appear to answer the question that it cannot even meaningfully ask. Tabarrok notwithstanding, the "theorem" cannot be proved without indifference curves or at least some restrictions on preferences beyond "more is preferred to less."

Tabarrok's second criticism, that the proof of the theorem need not follow a specific sequence (if indifference curves are removed), depends upon how one poses the question to be answered. If the government offers what the original question appears to ask, both tax types simultaneously, then the choice is: You must pay M_0M_1 regard-

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less but you can select to pay either by income tax or by an excise tax on X, and the individual will not prefer one tax type to the other. If the government offers the excise tax first (at a fixed rate, for how else can it offer this option?), the individual (not bound by indifference curves) will substitute away from X to avoid the tax payment, then given the income tax alternative (with a zero tax payment), the individual will choose the income tax option and consume at the original point. If the government offers the income tax first (at a fixed amount, for how else can it offer this option?) the individual will adjust accordingly, then given the excise tax option (allowing the individual to choose the rate else the analysis is comparing a fixed excise tax rate with a fixed income tax amount), the individual will not prefer one type to the other. Sequence still matters, only now, without indifference curves, the solution is different.

Finally, Tabarrok failed to mention the most obvious result of the analysis (with or without indifference curves): The individual prefers not to be taxed. By extension, an individual will prefer a tax offering that provides *ceteris paribus*, more chances to avoid so as to lower his tax payment. In the real world, where the government cannot enforce equal tax payments for different tax types, an excise tax on one good tends to be more easily avoided and thus preferred to an income tax, *ceteris paribus*. However, in the real world governments rarely allow citizens to make such choices. Instead they impose broad-based taxes for the very purpose of extracting greater tax revenues and search for theories they can use to pacify the long-suffering taxpayer.

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Book Reviews

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Economic Freedom and Interventionism: An Anthology of Articles and Essays. By Ludwig von Mises. Selected and edited by Bettina Bien Greaves. Irvington-on-Hudson, New York: Foundation for Economic Education, 1990.

Admirers of Ludwig von Mises will welcome this new collection of 46 articles and essays, most from the 1950s and 1960s, many rescued from obscure publication, and some recently translated into English. The titles of the book's subsections, "Economic Freedom," "Interventionism," "Mises as Critic," and "Economics and Ideas," remind us that Mises dealt with the big issues. Except in the final section, the individual selections are short and pithy; but throughout the book and with variation in context and level of abstraction, Mises makes the strongest and most fundamental case in favor of a market economy and against socialism and interventionism.

Characteristically, Mises has no patience with those who seemingly feign ignorance of economics in order to bolster their case for central control or those who flaunt their ignorance in some misdirected criticism of the business community. He condemns these detractors roundly and brands them as hypocrites, idle babblers, and ignoramuses. But Mises has near-infinite patience with the layperson who is eager to understand economic principles. He argues both explicitly (e.g., pp. 157 and 179) and by example that writing for the layperson is an important task that economists must undertake. Unlike experts in the natural sciences, who can apply their knowledge without soliciting the understanding and sympathy of the general citizenry, experts in the field of economics must educate the public. We can have market solutions to economic problems only if the participants in our political process can see through the fallacies of socialism and interventionism and accept the outcome of the market process.

Economists must also be able to converse with one another over the full range of economic issues. Mises emphasizes the

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interconnectedness of economic phenomena when he writes that "Economics does not allow any breaking up into special branches" (p. 55). Here, the modern reader can take Mises's "does not" for an "ought not." The actual breaking up of economics into separate fields and subfields together with the insular nature of these highly specialized areas of concentration demonstrates, by its mocking contrast, the essential unity of economics.

Several of Mises's essays are linked substantively by recurring themes: The market does not favor big business or even business in general; it favors consumers. By their choices in the marketplace, consumers decide whether a business can get big, stay big, or stay in business at all. Consumers are sovereign in a market economy: their spending determines what it produces; their saving determines how fast it grows. The choices of consumers also determine indirectly the wage rates of workers. Interventionists who would override the market process that ties labor income to consumer spending and grant workers a larger share of business renevues on the basis of their proclaimed productivity misconceive the relationship between capital and labor. They fail to recognize that changes in labor productivity are attributable not to labor itself but to the capital that gives labor its leverage. To divert income away from capital and towards labor would be to discourage capital accumulation and hence to halt the increases in labor productivity that supposedly justified the income diversion. Mises identifies institutions that preserve ownership rights and maintain a sound monetary system as the essential prerequisites for encouraging saving, which finances capital accumulation, which makes labor productive, which maintains high living standards for the Western countries and distinguishes them from the underdeveloped countries.

The ultimate choice faced by the social scientist as citizen—and by the general citizenry—is the choice between a market system and a socialist system. Mises argues in terms of this either-or choice with great rhetorical effect using both overstatement and understatement. He argues (p. 55) that there can exist no middle way in the form of interventionism. The political dynamics of any such mixed economy result in either (1) interventionist policies pursued to the extreme of socialism or (2) the wholesale abandonment of interventionism in favor of the market system. In discussing a particular interventionist policy, farm subsidies enacted for the benefit of the independent farmer, Mises remarks in mid-paragraph (p. 209) that "One cannot subsidize a man to render him independent."

Though writing decades ago, Mises incorporates into his arguments many economic theories that have emerged full-blown only in

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recent years. He anticipates the kernel of truth in so-called rational expectations theory by criticizing Keynes for his implicit belief that inflation can deceive the public persistently and systematically (p. 72); he anticipates a key aspect of supply-side economics and its Laffer Curve in noting that governments resort to inflation when tax rates have been pushed beyond the point of maximum returns (p. 103). The reader will encounter several such passages which establish Mises's ideas as precursors of now-fashionable insights.

If there is a weakness that characterizes this collection of essays, it is Mises's tendency to underestimate the enduring appeal of the ideas he criticizes. For instance, he writes (p. 140) that "As an economic doctrine, Keynesianism is now [1964] dead" and (pp. 120–21) that with the posthumous publication of the third volume of Marx's *Das Kapital* [1894], "the essential dogma of the Marxian philosophy, the class conflict doctrine. . . , was unmasked as a flop." But even now, as much as then, Keynesian doctrine is still alive, and Marxian doctrine still masquerades as high theory. In fact, these two doctrines (Keynesian demand failures and Marxian class conflict) plus the equally fallacious Ricardian production theory have all been combined to produce the present-day Post Keynesianism.

Today, as always, the general citizenry needs to understand economic principles and to recognize economic fallacies. The champions of freedom, Mises reminds us, can win out only through economic education. Students of Misesian economics will recognize Mises as the champion of champions and will be grateful to Bettina Bien Greaves and the Foundation for Economic Education for giving these essays and articles a new life.

Roger W. Garrison
Auburn University

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If You're So Smart: The Narrative of Economic Expertise. By Donald N. McCloskey. Chicago: University of Chicago Press, 1990.

The book *If You're So Smart* continues and extends the analysis of positivism in economics presented in *The Rhetoric of Economics*. Here, once again, Donald McCloskey champions the claims of rhetoric. He applies his approach to several issues of economic history and lambastes economists who don the mantle of science for their forecasts of the future.

McCloskey's critics often condemn him as an irrationalist who wishes to substitute myths of his own devising for the dictates of reason.[1] This accusation the author firmly rejects. He does not wish to expel fact and reason from economics; instead, he wishes to clear a space for literary understanding. Method, in his view, rests on a "rhetorical tetrad—fact, logic, metaphor, and especially story" (p. 24). Economists cannot proceed untrammeled by the constraints of fact; however, the world does not compel a simple response but leaves room for alternative accounts.

These accounts make use of the devices of literary persuasion. Rather than speak of a theory that confronts reality, McCloskey prefers to talk of "metaphorical and narrative questions [which] answer each other" (p. 10). The use of rhetoric aims to convince. Truth in economics, as in other academic disciplines, rests to a large extent on consensus among the subject's practitioners.

McCloskey writes with clarity and force, ably applying in practice the literary skills he endeavors to promote. His views on proper method, however, strike me as largely unpersuasive. The positivists whom McCloskey opposes divide meaningful statements into two classes: empirical and necessary. Only the former type secures new knowledge since logical necessity is a matter of linguistic convention and analytic statements are tautologies. (Necessarily false state-

[1]An example of such is Hans-Hermann Hoppe, "In Defense of Extreme Rationalism: Thoughts on Donald McCloskey's *The Rhetoric of Economics*," *Review of Austrian Economics* 3 (1989): 179–214.

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ments are meaningful, but for obvious reasons these need not be taken up here.) Whatever in language is neither empirical nor necessary is in strict terms without meaning. To claim that murder is wrong, e.g., is simply to express one's rejection of killing. Nothing factual has been asserted.[2]

McCloskey remains the prisoner of the positivist theories he so roundly condemns. If positivists dismiss the unverifiable as poetry, McCloskey simply reverses the usual moral positivists draw from their partition of language. "Poetry" is not bad but good: science extends far beyond the limits to which positivists desire to confine it. Nowhere does McCloskey challenge the positivist theory of meaning itself. He fails to consider the view that strict knowledge may be obtained through other methods than those favored by positivists. (The praxeology of Mises is of course a key instance of such a view.) Instead, he tacitly agrees with his professed foes about scientific knowledge but calls for the inclusion in science of the emotive language that positivist method has as a principal aim to expel.

McCloskey states, e.g., "a metaphor used in an economic story is not 'true' in a simple way" (p. 64). By "metaphor" McCloskey does not intend a particular trope alone but rather all use of language which fails to be strictly factual in the positivist sense. Almost all statements used in economics count as metaphorical for McCloskey; since these statements are not fully verifiable they *cannot* be literally true. Of course, a metaphor in ordinary language is literally false: but, unless one accepts McCloskey's view of literal meaning, a "metaphor" is his extended sense can be an ordinary language sentence that is true without qualification. "The value of an economic good depends on its marginal utility" is, if I have understood McCloskey's usage, a metaphor, since the statement can be tested only approximately. But why not take the statement as non-metaphorically true, in the Austrian manner? I wish that McCloskey had examined the Austrian view, rather than simply embrace what his quondam Chicago colleagues reject while leaving unchanged their underlying analysis. Like them, he believes that the extent a statement cannot be verified, it lacks literal meaning.

One may, I think, go further. Even if McCloskey holds the view of literal meaning I have attributed to him, he ought still to examine the Austrian position. Praxeology starts from the axiom of action and a few additional assumptions and attempts to deduce the body of economic theory through common-sense reasoning. Mises devoted considerable effort to a refutation of positivism, and to good purpose.

[2]I do not wish to claim that all logical positivists adopt the group of positions noted here.

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But do his own findings require one to reject the positivist criterion of meaning? I do not think so, unless one adds (as nearly all positivists do) that a scientific statement must be subject to continual experimental test. But why must it? The common-sense reasoning used by Austrians seems to generate propositions that are empirical, to the satisfaction of the strictest supporter of verifiability. The fact that Austrians hold a different position about what sort of tests need to be used in science is altogether a different question. I do not wish to defend the verifiability criterion—quite the contrary. But even those who acknowledge it have no excuse to turn a blind eye toward praxeology.

McCloskey might reply that he has not neglected the deductive method. Praxeology claims to establish truth. In so doing, it falls victim to an argument McCloskey advances to show that we have no direct access to reality. (The argument is found in *Rhetoric* rather than *If You're So Smart*.) The argument is this: To determine whether our concepts accurately grasp reality would require us to examine reality without using our concepts, since it is their ability to convey truth which we wish to assess. But this we cannot do: We use concepts in all our knowledge. Absent any direct, non-conceptual grasp of reality, we must stay within the circle of our concepts. Once our inability to free ourselves from our conceptual net is accepted, we cannot shrink from the next step. We must recognize that we construct our concepts: they are found rather than made. To the extent that the Austrian method of deduction claims that its results are literally true, it must be rejected.

The argument just presented lacks the decisive force McCloskey, closely following Richard Rorty, attributes to it. What exactly is meant by the possibility that none of our concepts enables us accurately to grasp reality? "Negation" and "identity" are concepts we use: is there a "world-in-itself" to which they do not apply? The assumed non-conceptual world is, *ex hypothesi*, incapable of description. Why assume that it is possible?

The foregoing remarks do not suffice to dissolve skepticism. Even if some of our concepts cannot be imagined incapable of application, it does not follow that all of them share in this privileged status. Does not McCloskey's problem then recur? To determine whether a concept applies to reality, must one not "step outside" the concept and examine reality directly? And how exactly is one to do this?

This skeptical question cannot easily be answered, and I fear that I must take refuge in the evasion that this is not the place to address difficult issues in the theory of knowledge. Before turning from the issue, one needs to ask: Does McCloskey's problem require us to regard claims to knowledge as at least in part constructions based on metaphor rather than depictions of an independent world? Not at all.

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McCloskey's difficulty has to do with verification—how do we know that our claims to depict the world accurately are true? Even if the question cannot be answered, our claims have not been undermined. To elicit a skeptical outcome from his question McCloskey needs to add the controversial "KK" principle— if *S* knows *p*, then *S* knows that *S* knows *p*. (Perhaps a weaker variant of the principle will do.) Suffice it to say that the principle is a dubious one: absent an argument for it, McCloskey has succeeded only in raising an interesting question.

In any event, even if one were to grant McCloskey the gap he alleges between our concepts and reality, economics emerges unscathed. Economics is concerned with human action: questions about the world independent of our concepts do not arise in it. One might object that economics deals with land, natural resources, techniques of production, etc., as well as action. But this is not to the point, since the items just mentioned do not belong to the noumenal world. They fall under our concepts, whatever else might not. McCloskey's foray into epistemology, though valuable, is not relevant to economics.

Though I have considerable reservations about McCloskey on the theory of knowledge, he seems to me much better when he takes up questions within economics. He discusses insightfully the views of several economic historians on the British economy in the late-nineteenth century. He questions whether it is useful to speak of decline, when in point of fact the British economy was expanding. The higher growth rate of Germany in some industries hardly suffices to show disaster for Britain. Here McCloskey makes an excellent case for the value of attention to metaphor. His discussion of what "decline" means is a model of acute literary analysis. His presentation of the career of Alexander Gerschenkron, one of his teachers, is also informative.

Unfortunately, McCloskey cannot leave philosophy alone; and in the central issued addressed in his book, he mars an otherwise useful treatment by dubious remarks.[3] He denies that economists can accurately foresee the future of the economy. Toward those who make such predictions, he asks the "American question" that forms his title: If you're so smart, why aren't you rich? If anyone could foretell the economic future, he would be in a position to gain for himself fabulous wealth. Why would he disclose his goldmine to others?

McCloskey's skepticism about economic predictions fits in well

[3]McCloskey makes several technical mistakes. The statement about inflation in a parallel world should be in the indicative, not the conditional sense (p. 91). Leibniz did not hold that no possible worlds are similar to the actual world (p. 93). Church's theorem does not say that it is impossible to predict the future of mathematics (p. 131). A Pareto-superior change is confused with a condition of Pareto optimality; and a change that does not meet McCloskey's condition can be Pareto superior (p. 136).

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with the Austrian view, and his ironic account of economic forecasting amuses and instructs. At times, McCloskey fails to distinguish two separate issues: is it possible to predict the future of the economy? If it is, why would the information be disclosed to the public? Perhaps, for all McCloskey has shown, there *are* successful predictors who keep their methods to themselves. Of course, McCloskey does not deny that there are successful entrepreneurs. The point at issue is whether there are *methods* of foreseeing the future.

Worse is to come. McCloskey informs us: "Humans react to economic predictions in ways that dampen or magnify the prediction" (p. 121). Hence the disclosure of a prediction will result in its falsification, as people take account of it in guiding their behavior.

This argument begs the question. If a prediction is correct, then people will not react to it in a way that falsifies it. It is logically possible that they modify their behavior in the ways McCloskey specifies, but a successful prediction does not require logical necessity. To say that people *will* modify their behavior is just to assume that the prediction will fail, the presumable point of the argument.

McCloskey's claim that self-prediction is impossible fails for the same reason. He states: "The impossibility of self-prediction has become a commonplace in philosophy. You do not know today what you will decide tomorrow, unless you have already decided it, in which case it is not tomorrow but today that you decided it" (p. 130). Is that so? I know what I shall have for breakfast tomorrow, but I have not now *decided* what to have. That I shall do tomorrow. The impossibility involved in this last remark I am entirely unable to fathom.

Returning to his epistemological theme, McCloskey offers his readers an important lesson: "Dogmatic Marxists, dogmatic neoclassicals, dogmatic Austrian economists, dogmatic institutionalists, who have put each other's writings on an index of forbidden books, are ethically dangerous, all of them. They are true believers, or rather, believers in truth. The best lack all conviction, while the worst / Are full of passionate intensity" (p. 146).

McCloskey has misread the familiar lines: Yeats did not praise tolerance but described an imminent apocalypse. No doubt McCloskey, whose analysis of a Wallace Stevens poem (pp. 97–99) shows remarkable skill, knows "The Second Coming" perfectly well. Perhaps he is making a small joke at the unwary reader's expense. In any event, non-dogmatic is, if not the last adjective one would apply to McCloskey, very near the last.

David Gordon
The Ludwig von Mises Institute

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Robert Nozick: Property, Justice and the Minimal State. By Jonathan Wolff. Stanford University Press, 1991.

Jonathan Wolff sets himself an ambitious goal in *Robert Nozick*. His principal aim is to offer a guide to Nozick's *Anarchy, State, and Utopia*. Beyond this, he says that "part of [my] task will be to reconstruct Nozick's arguments and conclusions to make them as coherent as possible. . . . I shall try to clarify Nozick's reasoning and make good the gaps where necessary and possible, so that we might appreciate the force of the arguments, and subject them to rigorous examination" (p. 2).

Wolff succeeds admirably in presenting a simplified version of *Anarchy, State, and Utopia*.[1] His accomplishment deserves extra praise because he strongly opposes what he believes to be the political consequences of the work (p. viii), but nevertheless remains fair in his presentation. Wolff never stoops to caricature, and the quarrels I have with his discussion concern matters of interpretation, not outright errors.

Wolff's account suffers from one principal defect, which prevents me from wholeheartedly recommending it. The author conflates Nozick's position with that of other libertarians. Sometimes he criticizes Nozick for positions he does not hold, but other libertarians do; on other occasions he challenges libertarians generally for not answering difficulties just because Nozick does not address them. Wolff's mistake in large part stems from his acceptance of the arguments of G. A. Cohen, one of his teachers. Cohen, a Marxist political philosopher of great acuity, has devoted several articles to Nozick which suffer from the problem previously discussed.

The issue arises quite early: At page 4, Wolff refers to Nozick as holding that one has "rights of ownership over oneself." He amplifies this remark so that the "thesis of self-ownership" becomes the basic

[1]The book is concerned only with the Nozick of *Anarchy, State, and Utopia* (New York: Basic Books, 1974). Wolff notes Nozick's criticism of libertarianism in *The Examined Life* (New York: Simon and Schuster, 1989), but he does not discuss Nozick's later views at length (p. 2).

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principle of Nozick's system. In point of fact, Nozick never uses the term "self-ownership" in *Anarchy, State, and Utopia*. He does indeed hold that a person has rights over his or her body, in similar fashion to those such as Murray Rothbard who do use the term.

But much more than a difference in words is involved. In part because Wolff thinks that Nozick believes in self-ownership, he ascribes to him the position that all political rights consist of either rights over one's body or absolute rights to property. There is no room for civil liberties, that cannot be reduced to the two basic forms of rights. Murray Rothbard and several other libertarians do hold exactly this view, but Nozick does not. Rothbard contends, for example, that free speech dissolves as a problem if one reduces situations of conflict to their underlying basis in property rights. Nozick attempts no such reduction.

Wolff's introductory chapter is otherwise accurate. He rightly notes that Nozick, and libertarians generally, sharply distinguish between the morally right and the legally enforceable. If people do not have welfare rights, it does not follow that the poor should be cast aside. Wolff asks: "But if all aid were voluntary, how much would be forthcoming?" (p. 12). He proceeds to canvas some ideas on voluntary aid by Milton and Rose Friedman, and others; but he neglects Nozick's own comments on the issue. Nozick holds that if people democratically support welfare taxes, there is little reason to think they would refuse to give charity voluntarily. He questions whether welfare provision is a public good.

Wolff then turns to a fuller characterization of Nozick's position on rights. He points out that Nozick attaches great importance to the Kantian principle that one ought not to use others simply as means. Each person has a separate life, and people cannot be used as means to the welfare of others.

But why should people be treated as ends? Wolff notes that Nozick's response places great stress on the value of each individual pursuing a "self-shaping" life plan. He suggests that if one regards the meaning of one's life as more closely connected with others than does Nozick, a different view of rights might ensue (p. 29).

Here I think Wolff's slightly but significantly misapprehends Nozick's view. The prohibition against using others follows from the Kantian principle, not from Nozick's explanation of why people are morally valuable. Even if one were to adopt a view of life's meaning along the lines Wolff suggests, this would not directly challenge Nozick's view of rights. It would do so only if the new view required rejection of the Kantian principle, or a different interpretation of it from the one Nozick offers. But to claim this requires more argument then Wolff offers.

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Wolff presents as an example of a different view of rights a theory advanced by Samuel Scheffler, in which people have welfare rights as well as the negative rights favored by libertarians. In this view, "one necessary condition of leading a life is to lead a life" (p. 32). In order to lead a life, do not people require rights to food, shelter, etc.?

The argument has gone too fast. Granted that people need certain goods to lead meaningful lives, does it follow that they need the right to these goods as well? Why is not sufficient if they obtain the goods through charity? Further, Nozick's proposal, once more, is not that people should have a set of rights determined by the notion of a meaningful life; it is that political measures ought not to require using some people as means to the ends of others. Even if one needs certain goods to lead a meaningful life, welfare rights may give some people the right to use others as means. (Scheffler's suggestion is unsatisfactory as stated here (p. 31), since on its terms, if anyone's using a particular good would prevent someone else from having a reasonable chance of living a decent and fulfilling life, no one would have a right to the good. What then is to be done with it? I suspect that this could be "fixed up.")

There is one further problem in Wolff's discussion of Nozick on rights. In his discussion of self-defense and punishment, Wolff does not mention that Nozick's use of the term "punishment" is different from its ordinary language sense of the imposition of a penalty. Nozick means by punishment a penalty that exceeds compensation. His question: why may we punish? is not equivalent to: why may we use force to retaliate for violations of rights?

Probably the most difficult section of *Anarchy, State, and Utopia* is Part I, in which the minimal state is derived. On the whole, Wolff does an excellent job in presenting clearly the steps in Nozick's complex argument. I found particularly valuable his challenge to the view that a monopoly protection agency will arise from the state of nature. Nozick's argument rests on the assumption that a larger agency will tend to defeat a smaller one in cases of conflict. A snowballing effect will ensue in which more and more people will transfer to the large agency. Wolff contends that in some cases, a smaller agency may defeat a larger one (p. 56).

Wolff also presents some interesting challenges to Nozick's principle of compensation. In his sketch of the role risk plays in the derivation of the minimal state, he fails to place sufficient stress on the type of fear Nozick thinks risky behavior that threatens bodily harm generates. Those who employ risky decision procedures may induce this anxiety. Compensation for the fear in case of wrongful use of a procedure is not feasible, since the anxiety arises not from any

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given instance of the use of the procedures, but from perceptions of a general policy. It is for this reason that Nozick holds that the use of such procedures may be prohibited. "Prohibition" means that punishment, as earlier defined, may be imposed.

Wolff raises the pertinent question of why the dominant agency must compensate those who are disadvantaged by the prohibition of risky decision procedures, if one has no right to impose this risk. He overlooks the stress Nozick places on differences of opinion as to what constitutes an unacceptably risky procedure. A procedure need not be prohibited because its user, or a consensus of moral opinion, consider it too risky. Rather, the dominant agency acts on its own view of the matter. An example might be the prohibition of the use of majority verdicts in jury trials for criminal offenses. The user of the prohibited procedure who is compensated has not done something morally blameworthy.

Further, Wolff fails to note that the dominant agency has no rights that other agencies lack. Non-dominant agencies, or independents for that matter, may prohibit the dominant agency from using risky decision procedures on their members or themselves, respectively. The problem with their doing so is that the dominant agency will not accept their views about risky procedures and will win in case the dispute leads to forcible conflict.

Wolff considers at length Nozick's entitlement theory of justice. Naturally, he gravitates toward the Wilt Chamberlain case; and here his reliance on Cohen leads him in a misapprehension. The example depends for its force on the moral intuition that people have the right to make voluntary transfers of goods to which they are entitled. Wolff questions whether Nozick can use this claim, since he has not shown that the liberty of transfer follows from property rights. Nozick, he alleges, believes that "your liberty is only restricted if someone stops you from doing what you have a right to do" (p. 94). This contention rests on the view already mentioned that Nozick's political theory recognizes only self-ownership and property rights as legitimate moral claims. Cohen takes Nozick to be saying this, and Wolff wrongly follows in his footsteps. To reiterate, this position is not to be found in *Anarchy, State, and Utopia*. Likewise mistaken is the view that Nozick thinks "you are only forced to do something if someone . . . violates your rights" (p. 94). This misinterpretation, also taken over from Cohen, extrapolates from an analysis of coercion in a particular case—wage bargains in which there is no threat or use of overt violence—to a general theory of coercion.

Wolff rightly does not commit himself to accepting Cohen's supposition that the Lockean proviso is the sum and substance of

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Nozick's principle of property acquisition (pp. 113–14). Nozick does not specify a principle of acquisition at all, as Wolff also correctly notes. He might usefully have discussed work by Rothbard, Ellen Paul, and others, who have addressed this problem from a libertarian standpoint. Also, what Wolff aptly terms the "zipping back argument" (p. 108) does not show that Locke's proviso prevents property acquisition under all circumstances. This argument claims that if one appropriator fails to satisfy the proviso, no one can do so. It does so only if there is a "last" person who cannot appropriate while leaving as much and as good for others. Nevertheless, the argument does indeed show that a problem exists given what most Lockeans have in mind as the outcome of property acquisition.

Wolff is not convinced by Nozick's claim that taxation is on a par with forced labor. Wolff objects that there is a continuum between forced labor, on the one hand, and unrestricted liberty, on the other. Starting with slavery, we can gradually portray various states of affairs, each allowing greater liberty than its predecessor. Why is the infringement of liberty represented by taxation especially important? Depending on its severity, taxation may leave people relatively free.

Recourse to the prohibition of treating people as exclusively as means will I think enable us to see a difficulty in this argument. The various social states do not lie on the continuum that Wolff supposes. Rather, there is a gap between cases in which people are recognized as ends-in-themselves and those in which they are not. Within the latter class, some instances of coercion are more severe than others. But all suffer from the disqualifying defect of using some people for the benefit of others. In this way, taxation is akin to forced labor in an important respect.

Wolff discusses many other issues, but I think enough has been said to indicate the book's flavor. Wolff has amply achieved his goal of writing a useful introduction to Nozick. If he had in mind a more ambitious aim, i.e., a full-fledged assessment of the virtues and vices of Nozick's theory and of libertarianism as a whole, the verdict must be less favorable.

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The Ludwig von Mises Institute

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